

# Legal Policy Conflicts in International Banking

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“Neither a borrower nor a lender be; for loan oft loses both itself and friend.”

— Polonius to Laertes, in *Hamlet*, Act I, Scene iii.

## I. INTRODUCTION

The world debt crisis might never have occupied the front pages of our newspapers during much of the past decade if more attention had been paid to the advice old Polonius gave to young Laertes. More than one Secretary of the Treasury has tried to control a multibillion dollar problem of money addiction, whose resolution sometimes seems to lie in the realm of financial eschatology.<sup>1</sup>

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1. See, e.g., “Plan or No Plan, Debt Relief Is Not Around the Corner,” N.Y. Times, Apr. 9, 1989, § 4, at 1, col. 4; *Brady's Mexican Hat Trick*, THE ECONOMIST, July 29, 1989 at 61. At this writing, the so called “Brady plan” seems to have achieved only mixed results in significant debt reduction. On the present state of the debt crisis, see generally Whalen, *Brady Debt Plan: Dead in the Water*, N.Y. Times, at 38, cols. 2-3. See also Johnson, *Left Hand, Right Hand*, 139 THE BANKER 144 (1989); Farnsworth, *Financial Officials Fear Global Trade Imbalance*, N.Y. Times, Sept. 25, 1989, at D8, col. 1; Fuerbringer, *Mexico Says Banks' Move Could Reduce New Lending*, N.Y. Times, Sept. 25, 1989, at D1, col. 1; Moffett, *Mexico's Capital Flight Still Wracks Economy, Despite Brady Plan*, Wall St. J., Sept. 25, 1989, at A1, col. 6; Bartlett, *The Third World Debt Crisis Reshapes America's Banks*, N.Y. Times, Sept. 24, 1989, § 4, at 3, col. 1; Bartlett, *Third World Debt Woes*, N.Y. Times, Sept. 23, 1989, at 11, col. 1; Guenther, *Morgan Bolsters Loan Reserves by \$2 Billion*, Wall St. J., Sept. 22, 1989, at A3, col. 1; Quint, *Brady's Debt Plan Forcing Big Banks to Increase Losses*,

The debt crisis is part of the same sad story as capital flight. While bankers and politicians try to renegotiate unmanageable loans, capital fleeing the debtor countries often ends up as deposits in the lending banks. Much of this capital is exported as the result of an understandable desire to protect against local currency devaluation or an unstable political situation. A significant portion goes out in violation of exchange control or fiscal regulations.<sup>2</sup> In some cases the funds may have been obtained through corruption.

A century ago, debt default by a less developed country might have been dealt with by creditor-country gunboats or forced arbitration.<sup>3</sup> Today, however, the debt crisis plays itself out in legal policy conflicts, both *among* and *within* nations, and pits parochial national concerns against common global interests. Competing objectives of international banking law, each desirable when viewed alone, often clash with each other when extended.<sup>4</sup> Such policy conflicts arise *among* nations when vital interests of one country ask for sacrifice from another. For example, many Swiss bankers perceive Switzerland's tradition of banking secrecy as important to the ability of its financial institutions to attract deposits, while law enforcement officials in the United States see this secrecy as an instrument to facilitate violation of American securities and fiscal legislation. Policy clashes occur *within* a nation when fiscal concessions aimed at attracting foreign capital create inequity with local taxpayers and tempt domestic tax cheats to use foreign banks to disguise their identities. Finally, parochial national policies run counter to the common goal of international monetary cooperation when exchange controls designed to protect the value of one country's currency distort efficient capital flows that are in the interest of all members of the world community.

Lending to developing countries presents a springboard from which to explore policy conflicts in the law of international banking. We shall see that the "act of state" and "sovereign immunity" doctrines help to reduce the chance that awkward judicial decisions will impede the conduct of foreign relations by the executive branch of the government. But these doctrines do not marry well with the competing objective of encouraging lender confidence in international loan agreements. The International Monetary Fund Articles of Agreement attempt to address a related conflict between each member country's obligation to respect exchange controls of other members, and the common goal of free payments of interest on cross-border loans.

On the liability side of the bank's balance sheet,<sup>5</sup> clashes of policy relate to the

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N.Y. Times, Sept. 21, 1989 at 1, col. 1; Int'l Herald Tribune, Jan. 28, 1987, at col. 5. For a general history of the current debt crisis in the context of six centuries of cross-border lending, see Todd, *A Brief History of International Lending from a Regional Banker's Perspective*, 11 *GEORGE MASON L. REV.* 1 (1989).

2. See Walter, *The Mechanisms of Capital Flight*, in *CAPITAL FLIGHT AND THIRD WORLD DEBT* 103 (Lessard & Williamson eds. 1987). See also I. WALTER, *SECRET MONEY* (1985); Henry, *Where the Money Went*, *NEW REPUBLIC*, Apr. 14, 1986, at 20.

3. See D. Vagts, *Transnational Business Problems* 482 (1986).

4. Cf. *Walz v. Tax Comm'n of N.Y.*, 397 U.S. 664, 668-69 (1970) (Chief Justice Burger, in a different context, remarking on principles that would be extended but cannot because of the existence of competing principles, in the context of a first amendment challenge to a New York City tax exemption for religious organizations).

5. On bank accounting, see J. KOLTVEIT, *ACCOUNT FOR BANKS* (1986). On the asset side we find loans from the bank to its debtors. On the liability side are found deposits (obligations of the bank to depositors). Add liabilities to equity and the sum is assets.

use of economic regulation for political ends (such as the freezing of Iranian and Libyan bank accounts), the capital flight facilitated by "haven country" banking secrecy, and the way secrecy laws vital to one country's private banking industry impede the enforcement of revenue laws and securities regulations of another. Within the United States itself, the desire for secrecy may give rise to policy conflicts. To attract foreign capital to American markets, the government accommodates the foreign investor sensitive to maintaining anonymity by providing relaxed disclosure requirements for owners of foreign-targeted securities. However, to preserve the integrity of the tax system and securities markets, government agencies may need to compel the production of documents that the foreign investor would rather keep to himself and his banker. Even routine information reporting with respect to payments to persons claiming to be nonresident aliens creates a conflict between the investor's desire for anonymity and the government's concern for gathering information necessary to law enforcement.

The lack of confidence in the local economy that contributes to the flight of capital often reflects the same national problems that contribute to the debtor country's difficulty in honoring its loan obligations. The vicious circle completes itself when the flight of capital in turn depletes the foreign exchange available for the debtor country to repay its cross-border borrowings.

Developing nations are occasionally depicted as innocent victims of the greed of industrialized countries. This portrayal leads to suggestions that their debt be adjusted for the sake of what might be called international economic justice.<sup>6</sup> Yet many leaders of the borrower nations, some of them among the world's richest individuals, show little inclination to keep their own wealth in local assets, let alone share it with less fortunate compatriots.<sup>7</sup> A significant portion of this wealth leaves to be invested abroad or deposited in foreign banks.

Calls for forgiveness of Third World debt, in the name of economic justice or otherwise, raise hard questions. Where did the borrowed money go? To what extent will loan default chill the future cross-border lending needed to finance future development? How will debt reduction affect the soundness of banks in lender countries?

6. See, e.g., Statement of the World Christian Workers Movement (Mouvement Mondial des Travailleurs Chrétiens) that "the debt [of the Third World] and its payment are the fatal result of an international strategy arranged to maximize [rich country] profits." *Vie Protestante*, July 14, 1989, at 5. The French original reads *in extenso*:

Selon le MMTC, «la dette et son paiement sont le fatal résultat d'une stratégie internationale mise en place pour un profit maximum, et les modèles imposés qui en découlent ne tiennent compte ni des cultures, ni des besoins des peuples». Pour le MMTC, «ceux des pays du tiers monde sont obligés de travailler surtout pour rembourser la dette aux riches au détriment des besoins essentiels» qui sont les leurs, et ceux des pays industrialisés ont du mal à réagir solidairement contre le «laissez-faire laissez-passer politique ambiant».

See also UNITED CHURCH OF CHRIST, CHRISTIAN FAITH AND ECONOMIC LIFE 21-45 (prepared for 17th General Synod, U.C.C.) (A Smock ed. 1987).

Other views from the left are more sophisticated. See, e.g., Frankenberg and Knieper, *Legal Problems in the Overindebtedness of Developing Countries: The Current Relevance of the Doctrine of Odious Debts*, 12 INT'L J. SOC. L. 415 (1984), drawing attention to the doubtful developmental value of many loans contracted by third world countries. One may ask, however, whether their suggestion of creditor responsibility for determining borrower country needs is compatible with third world self-determination. It may be a situation where creditors are "damned if they do and damned if they don't."

7. See discussion of the Marcos, Mobutu and Suharto cases by the Ghana diplomat, B.N. Ayittey, *The Real Foreign Debt Problem*, *Wall Street J.*, Apr. 8, 1986, at 30, col. 3.

Too often, scholars forget that legal issues related to loans interact with legal problems engendered by deposits. To divorce one from the other distorts analysis. Banks lend other people's money. Loans on the asset side of a bank's balance sheet are financed by the deposits on its liability side.

The depositors, whose money the banks are using to fund credit, care above all for the security of the bank's assets, which is to say the recoverability of its loans.<sup>8</sup> However, the same depositors also seek confidentiality. Laws protecting confidentiality permit significant amounts of capital to be deposited with international banks in violation of exchange controls or fiscal rules,<sup>9</sup> which in turn makes it harder for developing countries to repay their loans. American attempts to lift foreign bank secrecy in order to compel information interfere with the deposit gathering necessary to fund loans. Routine information reporting raises a similar need to weigh the confidentiality sought by the depositor against the integrity of American tax and securities legislation.

Lending nation policies have not been models of consistency. American and European banks want to recover on foreign loans, yet support tax and secrecy measures to attract flight capital that in turn exacerbates the inability of some countries to pay their hard currency debts. American banks want to attract foreign deposits while their government freezes accounts of some of their biggest oil-producing customers. The United States puts high value on respect for promises when its banks want to recover on loans, yet imposes economic regulations that sometimes make it hard or impossible for its banks to deliver on their own promises to repay their depositors.

In the interest of a more efficient international banking system, resolution of these conflicts requires concession and compromise between allies and trading partners based on sensitivity to common values shared by the world economic community. To this end, scholars are called to face squarely the connectedness of legal choices in transnational finance, the tension in competing goals, and our inability to have it all.

## II. CROSS-BORDER LOANS: BANKS AS TRANSNATIONAL LENDERS

The fifteenth chapter of Deuteronomy requires creditors to cancel indebtedness every seven years.<sup>10</sup> Modern borrowers are not likely to be so lucky, at least not until the Messiah either arrives or returns, depending on one's theology.

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8. Critical regulatory issues include assuring careful accounting for problem loans and the maintenance of adequate capital-to-asset ratios and bad debt reserves.

In this connection the International Lending Supervision Act of 1983 required American banking agencies to determine reserves on bank balance sheets and loan loss provisions (against income) for loans to countries subject to a high transfer risk, and clarified minimum ratios of capital to total assets. 12 U.S.C. § 3904 (1988). *See also* BASLE COMMITTEE ON REGULATIONS AND SUPERVISORY PRACTICES (B.I.S.), REPORT ON INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (1988).

9. For a survey of some of the technical issues related to what is often called "private," or "high net worth," international banking the reader is immodestly referred to Park, *American Income Tax Aspects of Trans-Border Securities Investment*, 4 B.U. INT'L L.J. 67 (1986); Park, *Compelling Information from Foreign Corporations: Secrecy Law and U.S. Economic Regulation*, in INVESTMENTS IN UNITED STATES REAL ESTATE FROM A EUROPEAN PERSPECTIVE 385 (R. Zäch ed. 1985); Park, *Backup Withholding, Foreign Banks and Bearer Bonds*, 1 J. OF STRATEGY IN INT'L TAXATION 161 (1985).

10. *Deuteronomy* 15:1—"At the end of every seven years you shall grant remission of debts."

The debt crisis that manifested itself in the early 1980's has elsewhere received considerable public and scholarly attention, particularly with respect to attempts to reschedule loans to problem countries in order to avert the prospect of default.<sup>11</sup> Analysis has focused on the way that developing nations have been squeezed between the Scylla of high interest rates and the Charybdis of low foreign exchange earnings. Some commentators have noted the aggravation of the crisis due to flight of local capital, provoked by fear of inflation and political instability.

Whatever the fundamental causes and long term cures of the crisis, its resolution must be linked to confidence in the enforceability of cross-border loan agreements. The legal reliability of international credit contracts remains essential to any new lending to assist debtor nations. If international credit is to play a part in world development, financial institutions must feel secure in their ability to vindicate their right to be paid by foreign borrowers. The legal obstacles to such financial security include the act of state doctrine and sovereign immunity.

### A. *The Act of State Defense*

The act of state doctrine has been called "perhaps the most written-about topic in international law journals in this country."<sup>12</sup> A colleague in England once remarked, "With the act of state doctrine, you Americans have turned a simple choice-of-law rule into an industry."<sup>13</sup>

The *Restatement (Third) of Foreign Relations Law of the United States* formulates the act of state doctrine as follows:

In the absence of a treaty or other unambiguous agreement regarding controlling legal principles, courts in the United States will generally refrain from examining the validity of a taking by a foreign state of property within its own territory, or from sitting in judgment on other acts of a governmental character done by a foreign state within its own territory and applicable there.<sup>14</sup>

Much debate has focused on the theoretical basis of the doctrine, which is often viewed as originating almost a hundred years ago in *Underhill v. Hernandez*.<sup>15</sup> In this case an American citizen brought an action against a military commander to recover

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11. See, e.g., Barnett, Galvis & Couraige, *On Third World Debt*, 25 HARV. INT'L L.J. 83 (1984); *Default by Foreign Government Debtors*, 1982 U. ILL. L. REV. 1. See also Amaral, *Debt Crisis From the Point of View of the Debtor Country*, 17 N.Y.U. J. INT'L L. & POL. 633 (1985); Eskridge, *Les Jeux Sont Faits: Structural Origins of the International Debt Problem*, 25 VA. J. INT'L L. 281 (1985); Leiseca & Studwell, *Latin American Accounts Receivable: To Sue for Collection or to Refinance* 39 BUS. LAW. 495 (1984).

12. *The International Rule of Law Act: Hearing on S. 1434 Before the Subcomm. on Criminal Law of the Senate Comm. on the Judiciary*, 97th Cong., 1st Sess. 3 (1981) (testimony of Davis R. Robinson, Legal Advisor to the Department of State). For a representative listing of leading articles, see Chow, *Rethinking the Act of State Doctrine: An Analysis in Terms of Jurisdiction to Prescribe*, 62 WASH. L. REV. 397, 398 n.3 (1987).

13. John Collier, Fellow of Trinity Hall, Cambridge. Conversation with W.W. Park in October 1975.

14. RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 443 (1987).

15. 168 U.S. 250 (1897).

damages for alleged assaults and illegal confinement suffered in the course of a revolution in Venezuela. The court refused to determine liability on the grounds that American courts could not sit in judgment on the acts of a foreign state. Chief Justice Fuller stated:

Every sovereign is bound to respect the independence of every other sovereign State, and the courts of one country will not sit in judgment on the acts of the government of another done within its own territory. Redress of grievances by reason of such acts must be obtained through the means open to be availed of by sovereign powers as between themselves.<sup>16</sup>

Scholars have pointed out that the original jurisprudential underpinnings of the act of state doctrine lay in turn-of-the-century choice-of-law theory.<sup>17</sup> In the first decade of the century Holmes wrote that "the character of an act as lawful or unlawful must be determined wholly by the law of the country where the act is done."<sup>18</sup> The act of state doctrine was an expression of deference by the United States judiciary to the authority of foreign sovereigns within their own territories.

By the time the Supreme Court revisited the act of state doctrine in the 1960s a new justification had been proposed.<sup>19</sup> In 1964, the Court decided the well-known *Sabbatino* case, which involved expropriated Cuban sugar sold to Morocco by a New York sugar broker.<sup>20</sup> The bill of lading, representing the right to take delivery of the sugar, ended up in New York.<sup>21</sup> Deciding that title to the bill of lading was held by the Cuban government rather than the expropriated owner, the Supreme Court found "constitutional underpinnings" for its decision in the separation of powers between the executive and judicial branches of government.<sup>22</sup> Justice Harlan stated that the act of state doctrine on which his decision rested was exclusively an aspect of federal law.<sup>23</sup> Courts should not hinder the President and State Department in the conduct of foreign policy by passing judgment on the validity of acts by foreign governments with which the executive branch might negotiate. The act of state doctrine was thus no longer based primarily on deference to foreign law, but rather on the constitutional separation of powers between the executive and the judiciary.<sup>24</sup> Justice Harlan wrote:

The Judicial Branch will not examine the validity of a taking of property within its own territory by a foreign sovereign government, extant and recognized by this country at the time of the suit, in the absence of a treaty or other unambiguous agreement regarding controlling legal principles, even if the complaint alleges that the taking violates customary international law.<sup>25</sup>

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16. *Id.* at 252.

17. Chow, *supra* note 12, at 404-11.

18. *American Banana Co. v. United Fruit Co.*, 213 U.S. 347, 356 (1909).

19. Furthermore, because of the Supreme Court's intervening decisions in *Erie R.R. v. Tomkins*, 304 U.S. 64 (1938) and *Klaxon v. Stentor Elec. Mfg. Co.*, 313 U.S. 487 (1941), federal courts sitting in diversity cases had to apply the conflict rules of the state in which they were sitting. Unless the Supreme Court could find a federal basis for the act of state doctrine, there was a probability that conflicting decisions would result.

20. *Banco Nacional v. Sabbatino*, 376 U.S. 398 (1964).

21. *Id.* at 406.

22. *Id.* at 423.

23. *Id.* at 425.

24. Chow, *supra* note 12, at 444.

25. *Sabbatino*, 376 U.S. at 428.

In essence, the courts are giving the executive a law-making function. Absent an "unambiguous agreement," it is the President who should make claims for the United States as to the content of international law.

The act of state doctrine after *Sabbatino* has been likened to a special federal choice-of-law rule.<sup>26</sup> When the doctrine does not apply, the court will use the ordinary choice-of-law rules to determine the governing law. However, the act of state doctrine may trump the ordinary rule and impose foreign law despite an American public policy or a rule of international law that otherwise calls into question the applicability of the chosen foreign law.<sup>27</sup>

In addition to the separation of executive and judicial power, another compelling justification of the act of state doctrine lies in the greater predictability that it brings to transborder trade. The doctrine increases commercial certainty by reducing challenges to the ownership of property obtained abroad. A buyer of goods will know that he can safely import them into the United States without having to worry about American judges upsetting the validity of a foreign law on which the importer's title is based.

Several aspects of the act of state doctrine mitigate its unfairness to prior owners of expropriated property, particularly when the foreign law is fundamentally repugnant to our basic values. The prohibition on examining the validity of the foreign law might not apply when the State Department so requests. This "Bernstein exception" (so called for one Mr. Bernstein who had sued to recover property confiscated by the Nazis<sup>28</sup>) was elaborated in a case in which the State Department asked the court to ignore the act of state doctrine, and restore the property to its original owner.<sup>29</sup>

A second limit on the act of state doctrine may remove the doctrine from consideration where property is confiscated by the foreign state in clear violation of international law. According to Justice Harlan's articulation of the doctrine in *Sabbatino*, the doctrine does not apply if the issue is governed by a "treaty or other unambiguous agreement regarding controlling legal principles."<sup>30</sup> Moreover, the Hickenlooper Amendment,<sup>31</sup> enacted in reaction to the Supreme Court's decision in *Sabbatino*, provides generally that American courts are not to decline to decide, on the basis of the act of state doctrine, the validity under international law of a confiscation of property unless the President determines that the foreign policy interests of the United States require the doctrine's applicability in the case.<sup>32</sup> The Hickenlooper

26. Henkin, *Act of State Today: Recollections in Tranquility*, 6 COLUM. J. TRANSNAT'L L. 175 (1965). See also RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 443 Reporters Note 1 (1987) (The Restatement, for which Professor Henkin was chief reporter, states that the act of state doctrine operates as "a special rule of conflict of laws.").

27. See Kirgis, *Understanding the Act of State Doctrine's Effect*, 82 AM. J. INT'L L. 58 (1988); Gruson, *The Act of State Doctrine in Contract Cases as Conflict of Laws Rule*, 1988 U. ILL. L. REV. 519.

28. *Bernstein v. N.V. Nederlandsche-Amerikaansche Stoomvaart-Maatschappij*, 210 F.2d 275 (2d Cir. 1954); *Bernstein v. Van Heygen Freres Societe Anonyme*, 163 F.2d 246 (2d Cir.), cert. denied, 332 U.S. 772 (1947).

29. *Nederlandsche-Amerikaansche Stoomvaart-Maatschappij*, 210 F.2d at 376 (The State Department press release noted that "[t]he policy of the Executive, with respect to claims asserted in the United States for restitution of such property, is to relieve American courts from restraint upon the exercise of their jurisdiction to pass upon the validity of the acts of Nazi officials.").

30. *Banco Nacional v. Sabbatino*, 376 U.S. 398, 428 (1964).

31. 22 U.S.C. § 2370(e)(2) (1982).

32. For the remand of the case in which the Hickenlooper Amendment was pleaded successfully, see *Banco*

Amendment applies only in cases that involve title to physical property located in the United States.<sup>33</sup>

Finally, there is some support for the existence of a commercial activities exception to the act of state doctrine. In one case the Supreme Court has refused to recognize an act of state defense based on a Cuban repudiation of a commercial obligation to return overpayments by American cigar importers. Because it was only a minority of the Court that based its decision on a commercial activities exception,<sup>34</sup> authority for the commercial exception to the act of state doctrine is unclear.

The *Allied Bank* litigation<sup>35</sup> of the early 1980s highlights the impact of the act of state doctrine in a banking context. The story of three Costa Rican banks, all wholly owned by the Costa Rican government, begins when the banks succeeded to some of the assets and liabilities of a failed Cayman Island bank that had done most of its business in Costa Rica. These liabilities included a debt to a syndicate of thirty-nine American and European banks.<sup>36</sup>

In 1981 the Costa Rican Central Bank and the Finance Minister each issued an order which in essence prohibited payment of external debt, which is to say debt denominated other than in the local currency, without Finance Ministry approval.<sup>37</sup> These decrees led to a default, and the lenders in 1982 brought an action to enforce the promissory notes signed by the Costa Rican banks when they accepted assignment of the loans, and to recover the balance due of approximately \$4.5 million plus accrued interest. The Costa Rican banks had consented to the jurisdiction of courts in New York, the place of payment for the U.S. dollar denominated obligation.<sup>38</sup>

*Nacional v. Farr*, 383 F.2d 166 (2d Cir. 1967), *cert. denied*, 390 U.S. 956 (1968). See also Bazzyler, *Abolishing The Act of State Doctrine*, 134 U. PA. L. REV. 325, 393 n.395 (1986); Zamora, *Recognition of Foreign Exchange Controls in International Creditors' Rights Cases: The State of the Art*, 21 INT'L LAW. 1055, 1075 (1987).

33. 22 U.S.C. § 2370(e)(2) (1982).

34. *Alfred Dunhill of London, Inc. v. Cuba*, 425 U.S. 682 (1976). The decision was reached by a five to four vote. In Part III of the opinion of the Court, Justice White wrote that "the concept of an act of state should not be extended to include repudiation of a purely commercial obligation owed by a foreign sovereign or by one of its commercial instrumentalities." *Id.* at 695. This part of the opinion was joined only by Chief Justice Burger, Justice Powell, and Justice Rehnquist. Concurring opinions were filed by Justices Powell and Stevens, the latter of whom declared his agreement only with Parts I and II of the Court's opinion. *Id.* at 715. See also *Braka v. Bancomer*, 762 F.2d 222, 225 (2d Cir. 1985) (leaving the issue of the existence of a commercial activities exception in abeyance); Chow, *supra* note 12, at 419-20, n.150 (1987) (discussing *Dunhill* and listing lower court decisions for and against the commercial activities exception).

35. There were three decisions: *Allied Bank Int'l v. Banco Credito Agrícola*, 566 F. Supp. 1440 (S.D.N.Y. 1983) [hereinafter *Allied Bank I*], *aff'd*, 733 F.2d 23 (2d Cir. 1984) (unbound edition only, *reprinted* in 23 INT'L L. MATERIALS 742) (1984) [hereinafter *Allied Bank II*], *withdrawn vacated on reh'g*, 757 F.2d 516 (2d Cir.) [hereinafter *Allied Bank III*], *cert. dismissed*, 473 U.S. 934 (1985). Compare *Allied Bank* with *Callejo v. Bancomer*, 764 F.2d 1101 (5th Cir. 1985), in which Mexican exchange controls mandated payment of dollar deposits in Mexican banks in pesos at below market rates of exchange. The bank, an instrumentality of the Mexican government, was held to be entitled to sovereign immunity, although action by the depositor was precluded under the act of state doctrine. *Allied Bank* has generated voluminous comment by practitioners and scholars. See generally, Ebenroth & Teitz, *Winning (or Losing) by Default: The Act of State Doctrine, Sovereign Immunity and Comity in International Business Transactions*, 19 INT'L LAW. 225 (1985); Rendell, *The Allied Bank Case and Its Aftermath*, 20 INT'L LAW. 819 (1986); Note, *The Act of State Doctrine: Resolving Debt Situs Confusion*, 86 COLUM. L. REV. 594 (1986); Comment, *The Courts, the International Debt Crisis, and the Dilemma of Rescheduling: Rethinking the Allied Bank Decision*, 46 U. TORONTO FAC. L. REV. 578 (1988).

36. *Allied Bank I*, 566 F. Supp. at 1440, 1442.

37. *Id.*

38. *Id.*



The district court in the case accepted the borrower's act of state defense and followed the "separation of powers" rationale, stating:

A judgment in favor of Allied in this case would constitute a judicial determination that defendants must make payments contrary to the directives of their government. This puts the judicial branch of the United States at odds with policies laid down by a foreign government on an issue deemed by that government to be of central importance. Such an act by this court risks embarrassment to the relations between the executive branch of the United States and the government of Costa Rica.<sup>39</sup>

None of the exceptions to the act of state doctrine was found applicable by the district court. The court considered the Finance Ministry decree prohibiting payment of external debt to be "public in nature,"<sup>40</sup> rather than commercial.

After the district court denial of Allied Bank's motion for summary judgment in its favor, Costa Rica refinanced most of its debt with external creditors. However, one of the banks in the syndicate—Fidelity Union Trust Company of New Jersey—refused to go along with the rescheduling.<sup>41</sup> As leader of the syndicate Allied Bank appealed the district court decision on behalf of Fidelity Union.

The court of appeals affirmed the district court decision,<sup>42</sup> but on grounds of "comity," a concept akin to the "golden rule," under which the courts of one country will not upset rights or duties created in another country as long as the foreign acts are consistent with domestic policy of the forum. Each nation does unto others as it wants done unto itself.<sup>43</sup>

Comity differs from the act of state doctrine in that it will apply only if the foreign act is consistent with American policy. And in the first appellate-go-round, the court of appeals did so find the Costa Rican decrees. Letters from then Secretary of State George Schultz to the then House Speaker Thomas "Tip" O'Neill had expressed support for further bilateral aid to Costa Rica under the Foreign Assistance Act of 1961 despite defaults on payments of Costa Rican government obligations. The court analogized the Costa Rican decrees to a reorganization under Chapter 11 of the Bankruptcy Code, which permits an automatic stay of actions against the insolvent debtor. The court saw the decrees as a rescheduling that deferred repayment, not as a debt repudiation.

The initial *Allied Bank* decision sent shock waves through the financial community in New York. Many feared that the decision could jeopardize the status of New York as a center for financial transactions, in particular as an international

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39. *Id.* at 1444.

40. *Id.* at 1443.

41. As a bit player on the world debt scene, Fidelity Union had its own short-term interests at heart. By threatening to scuttle any possible Costa Rican rescheduling, it may have hoped that the heavily exposed major banks would buy out its position. However, even though a negotiated settlement might have been in the interest of the major lenders, the other creditors had to side with Fidelity on the legal issue to preserve their bargaining position. *See generally*, Comment, *supra* note 35, at 584.

42. *See Allied Bank II*, 733 F.2d 23 (2nd Cir. 1984). This opinion, vacated on rehearing, is found only in the advance sheets, not the final version of the published Federal Reports.

43. One classic formulation of the comity doctrine is found in *Hilton v. Guyot*, 159 U.S. 113 (1895), in which the Supreme Court held that a foreign judgment is not conclusive as to the merits of the claim without reciprocity of treatment to judgments of American courts.

clearing center for repayment of dollar loans. The business of the New York banks would be jeopardized if lenders doubted that American courts would enforce loan agreements against borrowers in countries that unilaterally restructure their external debt.

This fuss and consternation caused the court of appeals to grant a rehearing on the case. Almost a year later the same three judges<sup>44</sup> vacated their earlier decision and ordered the district court to grant summary judgment for the syndicate of lending banks.<sup>45</sup> Judge Meskill said the district court had erred in thinking that American policy was in accord with Costa Rica's unilateral rescheduling.<sup>46</sup> To enlighten the judges on American policy, the U.S. Justice Department had filed a brief *amicus curiae*, expressing concern that Costa Rica's unilateral rescheduling of its external borrowing might interfere with multilateral initiatives to resolve the world debt crisis and to provide equilibrium in the international balance of payments. Since the court on rehearing found the Costa Rican decrees inconsistent with U.S. policy, comity did not require their recognition.<sup>47</sup>

The court's position in the rehearing seems clearly correct as a matter of policy. To encourage new financing to debtor nations, commercial banks must have confidence in the reliability of cross-border credit agreements. This interest in general world welfare, as well as American parochial national interest in the welfare of its financial institutions, requires enforcement of freely accepted loan contracts. To permit a foreign sovereign borrower to postpone a debt unilaterally would undermine the relative certainty in international financial markets that forms the very basis of transborder financial cooperation, by denying a lender's legal right to repayment.

The court on rehearing refused to apply not only the concept of comity, but also the act of state defense. The prohibition on questioning a foreign act applies only as the act affects property located within the foreign nation's territory. The property subject to the Costa Rican decrees—the debt of the Costa Rican banks—was situated outside Costa Rican borders. Therefore the court could call into question the validity of the Costa Rican act without violating the act of state doctrine. It did just this, and refused to recognize the validity of the decree.

Determining debt situs is not an easy exercise.<sup>48</sup> Intangibles, including the duty to repay a loan, have no fixed location that can be determined the way one locates physical property such as wood or a bill of lading. The debt may be evidenced merely by an entry on a bank's books and in its computers.

An obligation to repay money might most logically be fixed in a country that has power to enforce the debt. Normally the country where the debt is payable would be

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44. Judges Meskill, Pierce, and Metzner.

45. *Allied Bank III*, 757 F.2d 516 (2d Cir. 1985).

46. *Id.* at 519.

47. *Id.*

48. A reporter's note to § 443 of the *Restatement (Third) of Foreign Relations Law of the United States* suggests that it would be preferable to approach the applicability of the act of state doctrine to intangibles not by seeking a situs, but by "determining how the act of the foreign state in the particular circumstances fits within the reasons for the act of state doctrine and the territorial limitation." *RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES* § 443 reporter's note 4 (1987).

the country that has jurisdiction over the debtor.<sup>49</sup> Since the debtors in *Allied Bank* were resident in Costa Rica, one might conclude that the debt had its situs in Costa Rica.

The court in *Allied Bank* found to the contrary, however, because Costa Rica could not completely extinguish the borrowers' obligations to pay dollars in New York. The taking of property attempted by the decrees could not be accomplished inside Costa Rica, because the debtors had agreed to payment in New York.

A similar reasoning about debt situs had been followed by the Second Circuit the previous year in the case of *Garcia v. Chase Manhattan Bank*.<sup>50</sup> Chase Manhattan customers had sued to recover on peso certificates of deposit purchased in Cuba in 1958 and confiscated the next year by Castro's revolutionary government. Chase had guaranteed repayment at any Chase branch worldwide, and could pay the certificate of deposit in New York as well as in Havana.<sup>51</sup> Although Chase had already turned over to the Cuban government the amount of the certificate of deposit, the court said that Chase had to pay again, this time to the depositor.<sup>52</sup> It was as if an armed gunman in Cuba had robbed the local branch of the bank and the head office had to bear the consequences. The court was apparently influenced by the fact that Chase officials had known that the safety of the funds was one of the principal purposes of its relationship with the plaintiffs. In effect, the court read into the deposit agreement what has been called a "last plane account" clause, by which in time of local national crisis (when the customer escaped on the last plane for Miami) the money would be transferred from the country of deposit to a safer haven.<sup>53</sup>

Two days after this decision, the highest state court in New York reached a contrary result in an almost identical set of facts involving the same bank but a different depositor. In *Perez v. Chase Manhattan Bank*<sup>54</sup> the New York Court of Appeals held that the act of state doctrine *did* apply to preclude inquiry into the

49. This is the rule of an eighty-year old U.S. Supreme Court case, *Harris v. Balk*, 198 U.S. 215 (1905) (overruled only as to the quasi-in-rem issue addressed in *Shaffer v. Heitner*, 433 U.S. 186 (1977)) (quoted recently by Judge Amalya Kearse in the *Wells Fargo* case, discussed *infra* at note 56). Compare the Swiss position. With respect to payment of a sum of money, the obligation is located, in the absence of a contrary agreement by the parties, at the residence of the creditor. Other obligations generally are located at the debtor's residence at the time the obligations were created. Article 74 of the Swiss Code des Obligations provides:

Le lieu où l'obligation doit être exécutée est déterminé par la volonté expresse ou présumée des parties. A défaut de stipulation contraire, les dispositions suivantes sont applicables:

1. Lorsqu'il s'agit d'une somme d'argent, le paiement s'opère dans le lieu où le créancier est domicilié à l'époque du paiement;
2. Lorsque l'obligation porte sur une chose déterminée la chose est délivrée dans le lieu où elle se trouvait au temps de la conclusion du contrat;
3. Toute autre obligation est exécutée dans le lieu où le débiteur était domicilié lorsqu'elle a pris naissance.

CODE DES OBLIGATIONS [Co.] art. 74 (Switz.).

For application of this principle, see the Swiss federal court decision in the *Maritime International Nominees Establishment v. Guinea*, Judgment of Dec. 4, 1985, Tribunal fédéral, Switz., 5 ASA Bull. 24, 26 (1986).

50. 735 F.2d 645 (2d Cir. 1984).

51. *Id.* at 646.

52. *Id.* at 650-51.

53. Judge Amalya Kearse's dissent argued that the debt was located in Cuba (even if it was also located elsewhere) because it could have been collected there. Consequently, she argued, the debt ceased to exist on payment to the revolutionary government. *Id.* at 651-53.

54. 61 N.Y.2d 460, 463 N.E.2d 5, 474 N.Y.S.2d 689 (1984).

validity of the Cuban expropriation. The presence of a Chase branch in Cuba meant the debt could be paid there. The fact that there were other countries where the deposit could also have been paid was not relevant.<sup>55</sup>

At first blush, the New York state decision seems the better one for the banking industry. When deposits are confiscated, banks will pay only once, not twice. On reflection, however, this rule might boomerang for the bankers. Where the shoe is on the other foot, and the American bank is the creditor of a foreign borrower, a rule that locates debts wherever they can be paid would seem to increase the probability of a court granting recognition to a foreign moratorium on payment.

In another recent case, *Wells Fargo Asia Ltd. v. Citibank*,<sup>56</sup> Citibank's Manila branch had accepted deposits from foreign financial institutions, and those deposits were frozen in 1983 by the Central Bank of the Philippines. Citibank's defense included the act of state doctrine. The trial court ultimately held that New York was the place of repayment; thus New York law would be applied in order to promote the parties' shared expectations. The Second Circuit, in an opinion by Judge Amalya Kearse, affirmed the conclusion that Citibank was liable because the parties had agreed to repayment in New York.

One commentator has expressed the opinion that the act of state doctrine should not apply at all in a case like *Allied Bank*, regardless of debt situs.<sup>57</sup> The validity of the foreign exchange control decrees, so the argument goes, is not in question. Rather, the issue is the liability of the defaulting debtor. This point may be illustrated at the level of an individual. If an American living in Paris claimed to be unable to pay off the mortgage on his Cape Cod summer home because his French bank account was blocked, an action by the lending bank to foreclose on the mortgage would not call into question the validity of the French restrictions on the bank account. If the loan could be repaid through sale of the house on Cape Cod (or other American assets) the French restrictions would not be fatal to the foreclosing lender. A similar reasoning could be applied to New York assets of foreign borrowers.

The practitioner pays attention to the act of state doctrine to protect his client. The scholar, however, must look at the doctrine's wisdom from a more general perspective. Whatever value the rule has in promoting security of title to tangible goods,<sup>58</sup> its application to intangibles such as debt is open to question. Perhaps the best conclusion to the matter is a quote from F.A. Mann, Britain's grand old man on the legal aspects of money: "It must be hoped that the United States . . . and England . . . will rid themselves of a doctrine that is unknown in the rest of the world, is alien to the judicial function, and should have no bearing on the effects of foreign exchange control."<sup>59</sup>

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55. *Id.* at 470, 463 N.E.2d at 9, 474 N.Y.S.2d at 693.

56. 852 F.2d 657 (2d Cir. 1988), *aff'd* 695 F. Supp. 1450 (S.D.N.Y. 1988). See generally Smedresman & Lowenfeld, *Eurodollars, Multinational Banks and National Laws*, 64 N.Y.U. L. REV. 733, 762-74 (1989).

57. Maier, Book Review, 21 TEX. INT'L L.J. 197, 201 (1985) (reviewing C. EBENROTH, *BANKING ON THE ACT OF STATE* (1985)).

58. See *supra* text following note 27.

59. Mann, 2 N.Y. INT'L L. REV. 10, at 14 (1988/89).

## B. *Sovereign Immunity*<sup>60</sup>

The act of state doctrine was not the only potential legal obstacle to enforcing the loan agreement against the Costa Rican banks. The district court in *Allied Bank* also had to deal with the jurisdictional defense of sovereign immunity,<sup>61</sup> by which agencies of one sovereign nation cannot be hauled into the court of another. Immunity from suit interacts with, but is distinct from, the act of state doctrine. Sovereign immunity is not a choice of law rule but rather a limit on jurisdiction.

One rationale for sovereign immunity that commends itself is similar to the justification for the act of state doctrine. In asserting jurisdiction over a foreign sovereign, the judiciary risks interfering with or hindering the executive branch of the government in its conduct of international relations.

The United States Foreign Sovereign Immunities Act (F.S.I.A.) grants immunity to foreign states unless one of several exceptions applies. A major exception distinguishes between the state's public acts—acts *jure imperii*—and its commercial acts—acts *jure gestionis*. Immunity from jurisdiction will not apply in cases arising from the state's entry into the marketplace. This distinction between commercial activity and public activity is at the root of what is referred to as the "restrictive" theory of immunity, as contrasted with the older theory of complete or absolute immunity with respect to all acts.

England followed an absolute immunity doctrine until the State Immunity Act of 1978 brought English law into line with that of the rest of the Western world. A "restrictive" view of immunity in England now limits immunity when the state has entered into a commercial transaction. The Act defines commercial transaction to include "any loan or other transaction for the provision of finance" and any guarantee of a financial transaction.<sup>62</sup>

The Swiss have added a wrinkle to their immunity doctrine by requiring a connection between the foreign act and Switzerland. The concept of *binnenbeziehung* (internal connection) was used to defend against attachment of assets in Switzerland to satisfy an arbitral award rendered against Libya in a dispute whose subject matter was unconnected to Switzerland.<sup>63</sup>

Not surprisingly, communist legal systems generally do not consider economic activities to be any less entitled to the prerogatives of a sovereign than noneconomic functions. As a matter of internal law, however, Soviet agencies are generally amenable to judicial and arbitral dispute resolution.<sup>64</sup> Nevertheless, communist concep-

60. See generally G. BADR, *STATE IMMUNITY* (1984); Delaume, *Sovereign Immunity and Public Debt*, 23 INT'L LAW. 811 (1989). For a European perspective, see Reymond, *Souveraineté de L'État et Participation à l'Arbitrage*, 1985 REVUE DE L'ARBITRAGE 517 (1985).

61. *Allied Bank I*, 566 F. Supp. 1440, 1442-43 (S.D.N.Y. 1983).

62. State Immunity Act, 1978, ch. 33, § 3(3)(b). In contrast, the absolute theory of sovereign immunity is illustrated by a British case of the last century, *Mighell v. Sultan of Johore*, [1894] 1 Q.B. 149 (C.A.). Under an assumed name the Sultan had proposed marriage. When he later changed his mind, the woman sued him for breach of promise. *Id.* The Sultan successfully escaped the consequences of his rash proposal by pleading sovereign immunity. *Id.* at 151, 153-54, 156, 160, 161, 164. See generally I. BROWNLIE, *PRINCIPLES OF PUBLIC INTERNATIONAL LAW* 325-29 (3d ed. 1979).

63. See the Swiss federal court decision in the "LIAMCO" saga. Judgment of June 19, 1980, Tribunal fédéral, Switz., 106 B.G.E. I. 142 (1980), reprinted in, 20 INT'L L. MATERIALS 15 (1981) (introductory note by Georges Delaume) (English translation submitted to U.S. Court of Appeals, D.C. Cir., in Nos. 80-1207 and 80-1252 (*LIAMCO v. Libya*)).

64. See, e.g., J. HAZARD, W. BUTLER & P. MAGGS, *SOVIET LEGAL SYSTEM* 244-47 (3d ed. 1977). On arbitration

tions of the role of the state see nothing unusual about a state descending into the marketplace.<sup>65</sup>

Returning to U.S. law, we note that the relevant statutory language setting forth the restrictive theory of the F.S.I.A. reads in part as follows:

A foreign state shall not be immune from the jurisdiction of courts of the United States or of the States in any case . . . in which the action is based upon . . . an act outside the territory of the United States in connection with a commercial activity of the foreign state . . . and that act causes a direct effect in the United States.<sup>66</sup>

There appears to be no consensus on characterization of the act—determining whether the act is commercial or governmental. In some societies the purchase of boots by the army, or wheat for the general population, might each be viewed as a public act, even though any merchant can purchase boots or wheat. To elaborate the concept of commercial activity one must make value judgments about the proper role of government.<sup>67</sup>

Whether or not an activity is commercial is determined under the F.S.I.A. by the nature of the transaction, not by its purpose.<sup>68</sup> This general principle is amplified by a helpful legislative history. The report of the House Judiciary Committee reads as follows:

Moreover, both a sale of bonds to the public and a direct loan from a U.S. commercial bank to a foreign government are activities which are of a commercial nature and should be treated like other similar commercial transactions. Such commercial activities would not otherwise give rise to immunity and would be subject to U.S. regulation, such as that provided by the securities laws.<sup>69</sup>

The execution of promissory notes, therefore, is a commercial activity.

The term “foreign state” in the F.S.I.A. includes a state “agency or instrumentality” (what the French might call an “*émanation*”).<sup>70</sup> A corporate entity that is a separate legal person, but whose shares are owned by the foreign state, would therefore be entitled to immunity.

Having cleared the hurdle of immunity from suit, the lender still has to enforce any judgment in its favor. Immunity from jurisdiction is distinct from immunity from execution. The law provides only meager exceptions to the rule prohibiting attachment or execution against the property of a foreign state. For example, property used

with Soviet and East European agencies, see Pechota, *International Economic Arbitration in the USSR and Eastern Europe*, 8 N.Y.L. SCH. J. INT'L COMP. L. 377 (1987).

65. See memorandum presented by Professor Ushakov, entitled *Jurisdiction Immunities of States and Their Property*, U.N. Doc. A/CN.4/371 (11 May 1983) (copy on file at Ohio State Law Journal). See generally I. BROWNIE, *supra* note 62, at 547–48. See also FOREIGN TRADE, INVESTMENT AND THE LAW IN THE PEOPLE'S REPUBLIC OF CHINA 547–48 (M. Moser ed. 1987).

66. 28 U.S.C. § 1605(a)(2) (1982).

67. See Leacock, *The Commercial Activity Exception to the Act of State Doctrine Revisited: Evolution of a Concept*, 13 N.C.J. INT'L L. & COM. REG. 1 (1988).

68. A “commercial activity” means either a regular course of commercial conduct or a particular commercial transaction or act. The commercial character of an activity shall be determined by reference to the nature of the course of conduct or particular transaction or act, rather than by reference to its purpose.

28 U.S.C. § 1603(d) (1982).

69. H.R. REP. NO. 1487, 94th Cong., 2d Sess., at 10 (1976).

70. 28 U.S.C. § 1603 (a) & (b) (1982).

in the commercial activity on which the claim is based will not be immune. Some property, such as central bank funds (absent an explicit waiver of immunity), is always immune except perhaps if the central bank functions as a commercial bank in a particular transaction.

With forethought, lenders can meet at least one risk of sovereign debt by negotiating renunciation of immunity. The sovereign immunity defense does not apply when the foreign state has expressly or implicitly waived its immunity, and express waivers of immunity apparently are the rule in international lending transactions.<sup>71</sup> Moreover, 1988 amendments to the F.S.I.A. provide that a foreign state generally will not be immune from jurisdiction in an action to enforce arbitration agreements or to confirm arbitral awards.<sup>72</sup>

Of course, a sovereign borrower's loss on jurisdictional immunity is not necessarily fatal to its defense. As already discussed, the finding of nonimmunity may become a meaningless exercise when the act of state doctrine applies.<sup>73</sup> Just as important, an American court that has jurisdiction under the terms of the F.S.I.A. must still have personal jurisdiction in the form of minimum contacts with the foreign entity.<sup>74</sup>

### C. *The International Monetary Fund Agreement*<sup>75</sup>

The International Monetary Fund Articles of Agreement add yet another consideration in recovery against a defaulting borrower subject to exchange controls. To reduce distortion of transnational trade and finance, the Fund's Articles of Agreement prohibit restrictions on "current" transactions without Fund approval.<sup>76</sup> Cur-

71. § 1605(a)(1). See Rendell, *supra* note 35. See generally Delaume, *supra* note 60.

72. The amendment provides that a foreign state does not enjoy immunity in any case:

In which the action is brought, either to enforce an agreement made by the foreign State with or for the benefit of a private party to submit to arbitration all or any differences which have arisen or which may arise between the parties with respect to a defined legal relationship, whether contractual or not, concerning a subject matter capable of settlement by arbitration under the laws of the United States, or to confirm an award made pursuant to such an agreement to arbitrate, if (A) the arbitration takes place or is intended to take place in the United States, (B) the agreement or award is or may be governed by a treaty or other international agreement in force for the United States calling for the recognition and enforcement of arbitral awards, (C) the underlying claim, save for the agreement to arbitrate, could have been brought in a United States court under this section or section 1607, or (D) paragraph (1) of this subsection is otherwise applicable.

28 U.S.C.A. § 1605(a)(6) (West Supp. 1989).

73. For this reason the American Bar Association in 1984 adopted a resolution that would amend § 1606 to provide:

(b) The federal act of state doctrine shall not be applied on behalf of a foreign state with respect to any claim or counterclaim asserted pursuant to the provisions of this chapter which is based upon an expropriation or other taking of property (including contract rights) without the payment of prompt, adequate and effective compensation or otherwise in violation of international law or which is based upon a breach of contract.

Senator Mathias sponsored legislation to this effect in 1985. S. 1071, 99th Cong., 1st Sess. (1985).

74. See *International Housing v. Rafidian Bank*, 712 F. Supp. 1112 (S.D.N.Y. 1989). See also *INT'L FIN. L. REV.*, Aug. 1989, at 39.

75. See generally F. MANN, *THE LEGAL ASPECT OF MONEY* 372-400 (4th ed. 1982); Ebke, *Article VIII, Section 2(b), International Monetary Cooperation and the Courts*, 23 *INT'L LAW* 677 (1989); Zamora, *supra* note 32, at 1063-69. See also Sandrock, *Are Disputes Over the Application of Article VIII (2)(b) of the IMF Treaty Arbitrable?* 23 *INT'L LAW* 933 (1989) (concluding that in most contexts Article VIII (2)(b) issues will be arbitrable under U.S. and West German law).

76. Articles of Agreement of the International Monetary Fund, Dec. 27, 1945, art. VIII(2)(a), 60 Stat. 1401, 1411, T.I.A.S. No. 1501, 2 U.N.T.S. 39, 66, *incorporated with same words*, Second Amendment to the IMF Articles, Apr. 1, 1978, 29 U.S.T.S. 2203, 2223, T.I.A.S. No. 8937 [hereinafter IMF Articles and Second Amendment to IMF Articles respectively].

rent transactions are defined as payments other than those for the transfer of capital and include:

1. payments due in connection with foreign trade, other current business, including services, and normal short-term banking and credit facilities;
2. payments due as interest on loans and as net income from other investments;
3. payments of moderate amount for amortization of loans or for depreciation of direct investments. . . .<sup>77</sup>

The same article that prohibits restrictions on current transactions also requires member countries to enforce each others' exchange controls when imposed consistently with the IMF Agreement. Article VIII(2)(b) provides:

Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member.<sup>78</sup>

As a member of the Fund, the United States must respect another member's foreign exchange controls even if they prevent foreign borrowers from repaying loans to American banks. This obligation will apply if the loan agreement is deemed to constitute an "exchange contract," and if the exchange controls are imposed consistently with the IMF Agreement, which is to say approved by the IMF or imposed on capital rather than current transactions.

As one might suspect, scholarly and judicial opinions are not unanimous as to what constitutes an exchange contract or what exchange controls are consistent with the IMF Agreement. Both questions were dealt with in *Libra Bank v. Banco Nacional*.<sup>79</sup> In *Libra Bank*, a \$40 million loan from a syndicate headed by a British bank to the Banco Nacional de Costa Rica was intended to finance sugar production and exports.<sup>80</sup> On default, consequent to the same exchange control decrees at issue in *Allied Bank*, suit against the borrowers was brought in New York.<sup>81</sup> Because the loan was found to have its situs outside Costa Rica, the act of state doctrine did not operate as a defense to payment.<sup>82</sup> Nor did the doctrine of comity apply to protect the borrower, since the Costa Rican exchange control decrees constituted a confiscation of property without compensation, repugnant to the U.S. Constitution and laws. After judgment for the lender, the Banco Nacional asked to reargue the case on the basis that the loans were "exchange contracts" and that the Costa Rican decrees were exchange control regulations imposed consistently with the IMF Agreement.<sup>83</sup>

The Court rejected both contentions. First, it gave a narrow interpretation to the word exchange contract, to include swaps of one currency against another but not to include all contracts involving monetary elements. The court rejected a broader view,

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77. Second Amendment to IMF Articles, Apr. 1, 1978, art. XXX, part d, 29 U.S.T.S. 2203, 2257-58.

78. IMF Articles, art. VIII(2)(b), 60 Stat. at 1411, 2 U.N.T.S. at 66, *incorporated with same words*, Second Amendment to I.M.F. Articles, 29 U.S.T.S. at 2223.

79. 570 F. Supp. 870 (S.D.N.Y. 1983).

80. *Id.* at 874.

81. *Id.* at 875.

82. *Id.* at 882.

83. *Id.* at 846.



suggested by the then General Counsel of the IMF, that an exchange contract includes any agreement between resident and nonresident calling for payment or transfer in currency whether domestic or foreign that can affect the member state's balance of payments.<sup>84</sup>

The Court in *Libra Bank* also found that Costa Rica had not borne its burden of showing that its exchange controls were imposed consistently with the IMF Articles, which would have meant either that the Fund approved the restrictions or else that the restrictions applied to capital rather than current transactions.<sup>85</sup>

#### D. Arbitration Agreements

An arbitration clause in the loan agreement is an intriguing prospect for lenders concerned with both sovereign immunity and the act of state defense. The arbitration clause could provide that disputes arising out of the loan will be settled by the arbitration rules of an institution such as the International Chamber of Commerce,<sup>86</sup> the London Court of International Arbitration,<sup>87</sup> or the American Arbitration Association.<sup>88</sup>

Arbitration agreements are one variety of forum selection clause,<sup>89</sup> and under American law will normally be enforced in international contracts. The line of Supreme Court cases in which forum selection clauses have been upheld goes back seventeen years to a case that involved reference to the High Court of London in a contract between a German and an American company.<sup>90</sup> Subsequently the Court explicitly extended its recognition of international forum selection clauses to arbitration agreements even if the contracts involved legal issues that could not have been arbitrated in a domestic context.<sup>91</sup> In 1985, the Supreme Court announced in a

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84. *Id.* at 899, 901. For Joseph Gold's narrow view of "exchange contract," see J. GOLD, *THE FUND AGREEMENT IN THE COURTS*, VOLUME II 281 (1982).

The broader view of the term "exchange contract" was also used to support the position of the United States in 1979 when President Carter froze Iranian dollar deposits in foreign branches of American banks under the International Economic Emergency Powers Act.

85. *Libra Bank*, 570 F. Supp. at 902. A narrow view of exchange contracts was also taken in England by the House of Lords in *United City Merchants v. Royal Bank*, [1983] A.C. 168. The case involved a letter of credit to finance a sale of equipment to a Peruvian company in violation of Peruvian exchange control regulations. Lord Diplock stated that an exchange contract was "confined to contracts to exchange the currency of one country for the currency of another . . . ." *Id.* at 188.

86. See generally W. CRAIG, W. PARK, & J. PAULSSON, *INTERNATIONAL CHAMBER OF COMMERCE ARBITRATION* (2d ed. 1990) [hereinafter I.C.C. ARBITRATION].

87. See *A Commentary on the Rules of the London Court of International Arbitration*, 10 Y.B. COM. ARB. 167 (1985).

88. See A.A.A. *SUPPLEMENTARY PROCEDURES FOR INTERNATIONAL COMMERCIAL ARBITRATION* (1986); R. CAULSON, *BUSINESS ARBITRATION: WHAT YOU NEED TO KNOW* (3rd ed. 1986).

89. On the danger of failing to select a forum in advance of the dispute, see *Amin Rasheed Corp. v. Kuwait Insurance*, [1984] 1 A.C. 50 (H.L.(E)), involving a Kuwaiti insurance company that had insured a cargo vessel owned by a Liberian corporation. In an action brought by the Liberian corporation, English courts refused to grant leave to serve process against the Kuwaiti defendant under R.S.C. Order 11.

90. *Bremen v. Zapata*, 407 U.S. 1 (1972) (oil rig towed from Louisiana to Italy).

91. *Scherk v. Alberto Culver*, 417 U.S. 5067 (1974). The case involved securities law issues. At the time, arbitration of most securities law issues was considered a violation of American public policy. Recent Supreme Court decisions have permitted arbitration of securities law cases, even in noninternational cases. See *Rodrigues de Quijas v. Shearson*, 109 S. Ct. 1917 (1989).

landmark case<sup>92</sup> that arbitration agreements will be enforced in international contracts even if the claims relate to fundamental, or "core," public policy issues such as those raised by antitrust laws that may not be arbitrable in a domestic context.<sup>93</sup>

Traditionally, arbitration has not been considered suitable for credit agreements. It may end up being a long, complicated, and expensive process even when nothing significant is in dispute except the borrower's willingness or ability to pay on a promissory note. Moreover, the arbitration agreement might impede the lender from using an expedited or summary procedure available in many national legal systems, such as the *droit cambiare* in France, under which court-ordered payment procedures simplify and accelerate the enforcement of commercial paper obligations.<sup>94</sup>

Arbitration, however, has a special *raison d'être* when loans involve foreign debt, because of the risk of defenses based on the act of state or sovereign immunity doctrines.<sup>95</sup> Moreover, arbitration has a role to play with respect to the debt-equity swaps discussed below.<sup>96</sup>

In 1988, two federal statutes were amended to give greater enforceability to arbitration agreements and awards involving foreign sovereigns. These are sometimes referred to as the "LIAMCO Amendments," because they clarified issues addressed in *Libyan American Oil Co. v. Libya*,<sup>97</sup> where sovereign immunity and the act of state

92. *Mitsubishi Motors v. Soler Chrysler Plymouth*, 473 U.S. 614 (1985).

93. See generally Park, *Private Adjudicators and the Public Interest: The Expanding Scope of International Arbitration*, 12 BROOKLYN J. INT'L L. 629 (1986).

94. The holder requests the Tribunal de Commerce to grant the order to pay, which will be served upon the debtor. After 30 days from the service, attachment will be granted if the holder asks the Tribunal to enforce the order. The debtor may file an objection during the 30-day period requiring the Tribunal to judge the validity of the note, which in practice takes less than a month. Under the American law the "holder in due course" of a negotiable instrument benefits from presumptions of validity as to a number of matters such as the genuineness of signature. See U.C.C. §§ 3-302, 3-305, 3-307 (1977).

95. See *Libyan Am. Oil Co. v. Socialist People's Libyan Arab Jamahiriya*, 482 F. Supp. 1175 (D. D.C. 1980), vacated, 684 F.2d 1032 (D.C. Cir. 1981) (ad hoc arbitration in Geneva); *Ipitrade Int'l, S.A. v. Federal Republic*, 465 F. Supp. 824 (D. D.C. 1978) (arbitration of International Chamber of Commerce in Switzerland). See generally Delaume, *State Contracts and Transnational Arbitration*, 75 AM. J. INT'L L. 784 (1981). On the related question of whether a state may avoid arbitration by relying on provisions of its own law prohibiting arbitration with a private party, see Paulsson, *May a State Invoke Its Internal Law to Repudiate Consent to International Commercial Arbitration (Reflexions on Benteler v. Belgium)*, 2 ARB. INT'L 90 (1986).

American courts have for some time found that arbitration clauses constitute implied waivers of jurisdictional immunity. The F.S.I.A. grants courts jurisdiction when the foreign state has "waived its immunity either explicitly or by implication." Some cases have required not only waiver, but also a clear connection between the lawsuit and the United States to provide minimum contacts over the parties, so as to satisfy the due process clause of the Constitution when the award is enforced. *Verlinden B.V. v. Central Bank*, 488 F. Supp. 1284 (S.D.N.Y. 1980), *aff'd*, 647 F.2d 320 (2d Cir. 1981) (The appeals court affirmed the district court's dismissal of an anticipatory breach action against Nigeria's central bank, but did so on constitutional, not statutory grounds.), *rev'd*, 461 U.S. 480 (1983) (The Supreme Court reversed the appeals court's constitutional theory and remanded to the appeals court for review of the district court's finding of a statutory lack of jurisdiction.). See also *International Housing v. Rafidian Bank*, 712 F. Supp. 1112 (S.D.N.Y. 1989).

96. See *infra* notes 126-39 and accompanying text.

97. 482 F. Supp. 1175 (D.D.C. 1980). The New York Arbitration Convention permits refusal of recognition and enforcement of an arbitral award if the subject matter of the difference is "not capable of settlement by arbitration." In *Libyan Am. Oil*, this defense was invoked successfully in proceedings to enforce an award resulting from nationalization of an American oil concession by Libya. The court held the nationalization to be a nonarbitrable subject matter because of the act of state doctrine. Since American courts would not judge the validity of a nationalization, the D.C. District Court would not enforce an award of arbitrators who had done so.

The correctness of the LIAMCO decision was questionable. The court was asked to enforce an award, not to pass on the validity of a foreign nationalization. The decision, vacated because of settlement between the parties, was

doctrine were raised as defenses to the enforcement of an arbitral award against Libya in a dispute arising out of the nationalization by Libya of American owned oil concessions.<sup>98</sup>

The Federal Arbitration Act now provides that "[e]nforcement of arbitral agreements, confirmation of arbitral awards, and execution upon judgments based on orders confirming such awards shall not be refused on the basis of the Act of State doctrine."<sup>99</sup> The F.S.I.A., as already mentioned, now generally denies a foreign state immunity from the jurisdiction of American courts in an action to enforce an arbitration agreement or to confirm an arbitral award.<sup>100</sup> Moreover, arbitration agreements have been held to constitute waivers of immunity in many countries even in the absence of special legislation.<sup>101</sup>

Arbitration agreements and awards are also enforceable under the 1958 New York Arbitration Convention, which has been ratified by more than seventy countries including the United States, the Soviet Union, most Western industrialized countries, and many developing countries.<sup>102</sup> The Convention requires recognition of the parties' agreement to arbitrate and the arbitrator's award. Thus the Convention gives parties to international contracts some hope that they may avoid the "home town justice" that might be meted out in foreign courts. The Convention contains a litany of limited defenses to enforcement of awards, designed to insure the basic procedural integrity of the arbitral process and the award's conformity with notions of fundamental public order.<sup>103</sup>

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effectively ignored six months later by a federal court in the same district, *American International Group v. Iran*, 493 F. Supp. 522 (D. D.C. 1980) enforcing an arbitral award in favor of insurance companies whose businesses in Iran had been nationalized. In light of the 1988 Amendments to the Federal Arbitration Act, LIAMCO would have to be decided differently today. 9 U.S.C.A. § 15 (West Supp. 1989) (Note that the Congress enacted two provisions to be codified at 9 U.S.C. § 15, one concerning inapplicability of the act of state doctrine in judicial enforcement of arbitral awards, and the other relating to appealability of court orders pursuant to arbitral awards.).

98. See generally Kahale, *New Legislation in the U.S. Facilitates Enforcement of Arbitral Agreements and Awards Against Foreign Sovereigns*, 6 J. INT'L ARB. 57 (1989).

99. 9 U.S.C.A. § 15 (West Supp. 1989). Compare § 9 of the British State Immunity Act of 1978, providing that when a state has agreed to arbitration in writing, that state is not immune with respect to court proceedings related to the arbitration. State Immunity Act, 1978, ch. 33, § 9.

100. 28 U.S.C.A. § 1605(a)(6) (West Supp. 1989). For the text of the statute, see *supra* note 72. The scope of the Amendment includes arbitration agreements and awards covered by the New York Convention and arbitrations that take place in the United States.

101. See, e.g., Judgment of Nov. 18, 1986, Cour de cass. (France) (*État français v. S.E.E. E.*), reprinted in 76 REV. CRIT. DROIT INT'L. PRIVÉ 786 (1987); see also accompanying note by P. Mayer.

102. Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 21 U.S.T.S. 2517, T.I.A.S. No. 6997, 330 U.N.T.S. 3 [hereinafter Arbitration Convention]; Act approved July 31, 1970, Pub. L. No. 91-368, 84 Stat. 692 (codified at 9 U.S.C. ch. 2 (1988) (the implementing legislation in the United States). See generally Aksen, *American Arbitration Association Arrives in the Age of Aquarius: United States Implements United Nations Convention of the Recognition and Enforcement of Foreign Arbitral Awards*, 3 SW. U.L. REV. 1 (1971); McMahon, *Implementation of the United Nations Convention on Foreign Arbitral Awards in the United States*, 2 J. MAR. L. & COM. 735 (1971); Quigley, *Accession by the United States to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards*, 70 YALE L.J. 1049 (1961); Van Mehren, *The Enforcement of Arbitral Awards Under Conventions and United States Law*, 9 YALE J. WORLD PUB. ORD. 343 (1983). See also I.C.C. ARBITRATION, *supra* note 86, ch. 37; A. VAN DEN BERG, *THE NEW YORK ARBITRATION CONVENTION OF 1958* (1981).

103. 1. Recognition and enforcement of the award may be refused, at the request of the party against whom it is invoked, only if that party furnishes to the competent authority where the recognition and enforcement is sought, proof that:

(a) The parties to the agreement referred to in article II were, under the law applicable to them, under some

American enthusiasm for arbitration agreements and awards has not been shared by developing countries. In 1974, notions of a "New International Economic Order" were incorporated into a United Nations General Assembly Resolution entitled *The Charter of Economic Rights and Duties of States*.<sup>104</sup> Presumably the Charter would apply to disputes relating to debt swapped for equity, as outlined below.

The Charter rejected the principle that compensation for expropriation of foreign-owned property should be determined according to neutral international tribunals. Article 2(2)(c) of the Charter requires compensation for nationalized property to be determined solely by host-state courts, which effectively excludes neutral arbitration:

In any case where the question of compensation [for expropriated property] gives rise to a controversy, it shall be settled under the domestic law of the nationalizing State *and by its tribunals* . . . .<sup>105</sup>

This part of the Charter has been rejected as not legally binding by at least one arbitrator in a dispute concerning the Libyan government's nationalizations of properties owned by Texaco and Standard Oil of California.<sup>106</sup>

The provisions of Article 2(2)(c) echo the doctrine that bears the name of the nineteenth century Argentinean jurist, Carlos Calvo, who proposed a general principle of equal treatment for Latin American nationals and foreign investors. The

incapacity, or the said agreement is not valid under the law to which the parties have subjected it or, failing any indication thereon, under the law of the country where the award was made; or

(b) The party against whom the award is invoked was not given proper notice of the appointment of the arbitrator or of the arbitration proceedings or was otherwise unable to present his case; or

(c) The award deals with a difference not contemplated by or not falling within the terms of the submission to arbitration, or it contains decisions on matters beyond the scope of the submission to arbitration, provided that, if the decisions on matters submitted to arbitration can be separated from those not so submitted, that part of the award which contain[s] decisions on matters submitted to arbitration may be recognized and enforced; or

(d) The composition of the arbitral authority or the arbitral procedure was not in accordance with the agreement of the parties, or, failing such agreement, was not in accordance with the law of the country where the arbitration took place; or

(e) The award has not yet become binding on the parties, or has been set aside or suspended by a competent authority of the country in which, or under the law of which, that award was made.

(2) Recognition and enforcement of an arbitral award may also be refused if the competent authority in the country where recognition and enforcement is sought finds that:

(a) The subject matter of the difference is not capable of settlement by arbitration under the law of that country; or

(b) The recognition or enforcement of the award would be contrary to the public policy of that country.

Arbitration Convention, art. V, 21 U.S.T.S. at 2520, 330 U.N.T.S. at 40-42.

See generally Park, *National Law and Commercial Justice: Safeguarding Procedural Integrity in International Arbitration*, 63 TULANE L. REV. 647 (1989).

104. G.A. Res. 3281, 29 U.N. GAOR Supp. (No. 31) 50, U.N. Doc. A/9631 (1974). Adopted by a vote of 120 to 6 (with 10 abstentions). The negative votes were cast by Belgium, Denmark, the Federal Republic of Germany, Luxembourg, the United Kingdom, and the United States. The Charter was essentially the work of the developing nations that hoped to give legal form to the economic aspirations articulated during the previous decade through the United Nations Conference on Trade and Development (UNCTAD).

105. *Id.*

106. See International Arbitral Tribunal: Award on the Merits in Dispute Between Texas Overseas Petroleum Company/California Asiatic Oil Company and the Government of the Libyan Arab Republic, 17 INT'L L. MATERIALS 1 (1978). The Libyan government argued that the principles of the New International Economic Order precluded the jurisdiction of any international tribunal. Professor René-Jean Dupuy, the arbitrator, however, found that the principles of Article 2(2)(c) did not represent the general will of the community of nations, and denied their legal effect. Had Article 2(2)(c) been deemed legally binding by the arbitrator, with retroactive effect, the arbitrator would have been without jurisdiction to decide the dispute, and the companies' only recourse would have been before Libyan national courts.

Calvo doctrine finds its embodiment in legislative and constitutional provisions of many Latin American countries granting exclusive jurisdiction to local courts.<sup>107</sup> A Latin American court therefore could strike down a forum selection clause violative of the local statutory enactment of the Calvo doctrine. An arbitral tribunal itself, however, might react differently to such a public policy.

An arbitration agreement, as already mentioned, is only one variety of forum selection clause. Dispute resolution by a neutral country court is also an option. Fear of judges' national prejudices or predispositions, however, may prevent the parties from agreeing on a national court to hear their dispute. Lawyers from companies based in industrialized nations may lack confidence in judges from countries without a tradition of judicial independence. Developing nations may resist reference to courts of former colonial powers, despite their legal and commercial sophistication.

Just as importantly, one cannot always be certain in advance that a foreign national court will accept jurisdiction. Many courts will not accept jurisdiction of disputes between foreign parties without a connection between the dispute and the country of the forum.<sup>108</sup> No such limits are likely to arise if the parties refer to arbitration.

Only English Courts, to the best of my knowledge, have shown themselves enthusiastic toward taking jurisdiction pursuant to forum selection clauses covering disputes between foreign parties concerning controverted events occurring abroad. In a dispute arising from a collision between Dutch and Belgian vessels in Belgian waters, the eminent Lord Denning ruled that the English Admiralty Court could accept the election of one of the parties to bring an action in England. "You may call

107. See Leavy, *The Calvo Doctrine in Latin American Loans*, INT'L FIN. L. REV., OCT. 1985, at 31.

108. For example, New York limits the right of a foreign corporation to bring an action against another foreign corporation. N.Y. BUS. CORP. LAW § 1314 (McKinney 1989) provides:

(b) Except as otherwise provided in this article, an action or special proceeding against a foreign corporation [not formed under the laws of the United States and maintaining an office in New York] may be maintained by another foreign corporation. . . in the following cases only:

(1) Where it is brought to recover damages for the breach of a contract made or to be performed within this state, or relating to property situated within this state at the time of the making of the contract.

(2) Where the subject matter of the litigation is situated within this state.

(3) Where the cause of action arose within this state, . . .

(4) Where . . . a non-domiciliary would be subject to the personal jurisdiction of the courts of [New York under its long arm statute].

(5) Where the defendant is a foreign corporation doing business or authorized to do business in the state.

*Id.*

N.Y. BANKING LAW § 200-b (McKinney 1989) contains similar limits related to actions against foreign banks.

The effect of both on this rule was modified in 1984 by the enactment of Section 5-1402 of the N.Y. General Obligation Law, which provides:

[A]ny person may maintain an action or proceeding against a foreign corporation, non-resident, or foreign state where the action or proceeding arises out of or relates to any contract, agreement or undertaking for which a choice of New York law has been made . . . and which (a) is a contract, agreement or undertaking, contingent or otherwise, in consideration of, or relating to any obligation arising out of a transaction covering in the aggregate, not less than one million dollars, and (b) which contains a provision or provisions whereby such foreign corporation or non-resident agrees to submit to the jurisdiction of the courts of this state.

N.Y. GEN. OBLIG. LAW § 5-1402 (McKinney 1989). N.Y.C.P.L.R Rule 327 provides that actions shall not be dismissed for forum non conveniens when § 5-1402 applies and the parties have selected New York law.

Moreover, § 5-1401 provides that whenever a transaction involves more than two hundred and fifty thousand dollars, the parties may submit their contractual rights and duties to New York law regardless of whether their agreement has any reasonable relationship to New York state. N.Y. GEN. OBLIG. L. § 5-1401 (McKinney 1989).

this 'forum shopping' if you please," wrote Denning, "but if the forum is England, it is a good place to shop in, both for the quality of the goods and the speed of service."<sup>109</sup>

If bankers do swap loans for equity participation in the local borrower, as discussed in the next section, arbitral resolution of disputes might proceed under the rules of the private institutions already mentioned.<sup>110</sup> In addition, the World Bank's International Center for Settlement of Investment Disputes (ICSID) would also be an option.<sup>111</sup> Here as elsewhere, the mechanics of both the problem and its solution involve several interdependent conceptual elements.

#### E. *Restructuring, Securitization, and Debt-Equity Swaps*<sup>112</sup>

When American commercial banks with foreign loan portfolios received the shock of the 1982 Mexico moratorium on its payments of debt principal,<sup>113</sup> the bankers responded by trying to reschedule debt coming due in the short term. The lenders, the borrowers, and the International Monetary Fund (IMF) succeeded in working out terms that allowed at least some of the immediately due commercial debt to be restructured.<sup>114</sup> Later some debtors and their creditors undertook to reschedule loans coming due in the medium term.

Negotiated with the best of intentions on all sides, these restructurings have not provided a satisfactory solution to the debt crisis. For example, the first major rescheduling of Brazilian debt took place in February, 1983. A condition of that rescheduling was that Brazil sign an agreement with the IMF requiring adherence to an economic austerity program. Brazil failed to meet the IMF economic performance targets, the terms of the rescheduling had to be renegotiated, and additional austerity programs had to be implemented.<sup>115</sup> The failure of some debtors to meet even the

109. The *Atlantic Star*, [1973] 1 Q.B. 364, 382 (C.A.). Maritime collisions, of course, may present a special situation because of the peculiar nature of admiralty in rem actions. In the absence of a valid forum selection clause, relevant jurisdictional rules are found in R.S.C. Order 11, which gives English courts jurisdiction, *inter alia*, to enforce contracts governed by English law. For English rules on forum non conveniens, see *Spiliada Maritime v. Cansulex*, [1987] A.C. 460, holding that a stay of litigation will be granted when another competent forum is available and England is not the natural or appropriate forum. See generally A. DICEY & J. MORRIS, *THE CONFLICT OF LAWS* 393-95 (11th ed. Supp. 1989).

110. For example, the American Arbitration Association, the International Chamber of Commerce, or the London Court of International Arbitration. See *supra* notes 86-88 and accompanying text.

111. ICSID arbitration has its own enforcement mechanism. An ICSID arbitration award rendered under the aegis of the World Bank might not be enforced in countries where sovereign immunity otherwise posed an obstacle. The ICSID treaty does not prevent a sovereign immunity defense under the law of the country executing the award. Convention on the Settlement of Investment Disputes, *opened for signature* Mar. 18, 1965, art. 55, 17 U.S.T.S. 1270, 1292, T.I.A.S. No. 6090, 575 U.N.T.S. 159, 194.

112. For a survey of debt reduction techniques, see Quale, *New Approaches to LDC Debt Restructuring and Disposition: U.S. Legal and Accounting Considerations*, 23 INT'L LAW. 605 (1989).

113. See *Mexico Seeks to Stop Paying Debt Principal*, Wall St. J., Aug. 20, 1982, at 2, col. 2.

114. See generally Reisner, Gruson & Thomas, *International Banking Symposium: Foreword*, 1988 U. ILL. L. REV. 219, 222.

115. See generally Zimble, *Debtor Law and Default: Enforcement of Foreign Loan Agreements in Brazilian Courts*, 17 U. MIAMI INTER-AM. L. REV. 509 (1986). See Deposit Facility Agreement Between Banco Central do Brasil and Republica Federativa do Brasil (as Guarantor, and Citibank N.A. (as Agent)) et al., Feb. 23, 1983, and a subsequent agreement between the same parties, Jan. 27, 1984.

rescheduled terms has led to a series of restructurings<sup>116</sup> that assumes the banks will continually roll over the principal if the debtor keeps interest current and agrees to an economic adjustment program.<sup>117</sup>

Restructurings bring problems of their own. The interest burden that results from these arrangements usually dampens hope of economic recovery by debtor countries. The drain on their foreign currency earnings leaves many developing countries in what has been called a "kind of financial coma."<sup>118</sup> Moreover, commercial lenders are understandably less than eager to make the new loans required by the debtor economies. Rescheduling does not meet the debtor's needs for new money. The banks are thus forced to confront the prospect of voluntary restraint and the writing down of their foreign loans.

The political ramifications of supervision of debtor country economies monitored by foreign banks or the IMF are likewise not appealing as a permanent solution.<sup>119</sup> Wrenching economic programs undertaken in order to prove that the debtors are becoming better credit risks serve as first-aid during the initial shock but become unsatisfactory as long-term treatment. If principal owed by debtor countries remains at its current high level, no financial legerdemain or accountants' jiggery-pokery will succeed in reducing the pain of debt service.

The inadequacy of restructuring as a solution to the world debt problem has led to other techniques geared primarily towards debt reduction. The first is debt securitization.<sup>120</sup> This technique repackages developing country loans into financial instruments such as bonds, which the creditor banks can market to third-party investors.

The engine driving securitization for the debtor is the discount off the initial value of the debt. It is a straight debt-for-debt swap, with the added attraction for the lender of a guarantee on principal and, for the Brady Plan, on interest as well. Morgan Guaranty put forth such an "exit bond" plan for Mexico that involved the replacement of existing debt, at a discount, with Mexican securities.<sup>121</sup> The principal of the new securities would be guaranteed by twenty-year zero-coupon U.S. Treasury bonds held in escrow by the Federal Reserve Bank of New York. Mexico intended to pay two billion dollars out of its foreign currency reserves to purchase U.S. Treasury zero-coupon bonds worth ten billion dollars at maturity in 2008, and to auction its own securities to those banks offering the greatest discount on existing debt. In this way, Mexico could potentially retire a substantial portion of its debt.<sup>122</sup>

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116. *Repeat Performance*, THE ECONOMIST, July 8, 1989, at 72.

117. Buchheit, *Alternative Techniques in Sovereign Debt Restructuring*, 1988 U. ILL. L. REV. 371, 373.

118. *Id.* at 374.

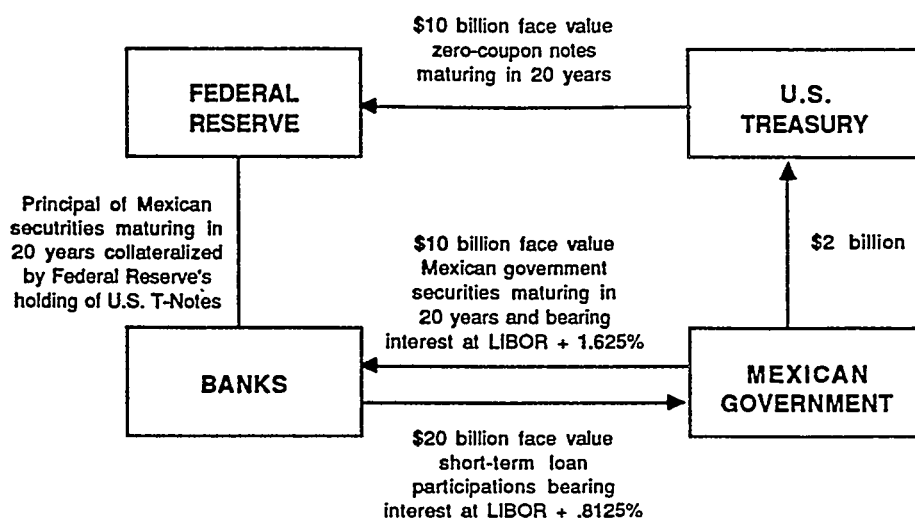
119. For example, the President of Peru is reported to have urged the largest debtor nations to stop payments in a "financial disarmament" plan. Boston Globe, Sept. 5, 1989, at 16, col. 1. (report on Belgrade annual meeting of nonalligned movement).

120. See Plehn, *Securitization of Third World Debt*, 23 INT'L LAW. 161 (1989).

121. The plan's longer title was "Invitation from Gustavo Petrocelli, Minister of Finance and Public Credit of the United Mexican States to the Banks Party to Mexico's Public Sector Restructure and New Restructure Agreements and 1983 and 1984 New Money Agreements to Exchange Existing Indebtedness For United Mexican States Collateralized Floating Rate Bonds Due 2008 (Jan 18, 1988)." See Guenther, *Here Are Main Points of Plan for Mexico to Reduce its Debt by Billions of Dollars*, Wall St. J., Dec. 30, 1987, at 6.

122. Plehn, *supra* note 120, at 163-64.

The scheme has been diagrammed as follows:<sup>123</sup>



Unfortunately, however, the auction did not go as well as Mexico hoped. The bids discounted the existing debt at an average of thirty percent, rather than the hoped-for fifty percent, and only \$3.67 billion of old debt was exchanged for \$2.56 billion in new.<sup>124</sup> Furthermore, a year and a half later, the bonds apparently are trading at a 25% discount due to continued uncertainty about the Mexican's ability to pay the unsecured interest.<sup>125</sup>

Another version of debt securitization was attempted under the auspices of the so-called Brady Plan. To encourage bankers to make new loans, the Mexicans offered exit options. First, the Mexicans would swap loans at face value for 30-year bonds paying a below-market rate of 6.25% yearly interest. Alternatively, the banks could swap their loans at a 35% discount for 30-year bonds paying a market interest rate. As was the case for the Morgan Plan, the principal of the bonds was backed by zero-coupon U.S. Treasury bonds, financed by a loan from the IMF. Interest was also guaranteed up to a point to be determined by the amount of new loans received.<sup>126</sup>

The recent decision by J.P. Morgan to increase its loan loss reserve to 100% of its medium and long term debt portfolio has been interpreted as the death of the Brady Plan.<sup>127</sup> Increased reserves mean that banks will make lending decisions as they wish, based on the borrower's economic outlook rather than political considerations.

123. See Price Waterhouse Study: Regulatory Accounting and Tax Aspects for Sovereign Risk Lending, September 1989, at page 7. The Mexicans assumed a 50% reduction, but in the end were disappointed.

124. Plehn, *supra* note 120, at 164. The amount sold was limited by the Mexicans, who refused to accept bids that insufficiently discounted the existing loans.

125. *Mexico's Bankers Head for the Border*, THE ECONOMIST, Aug. 12, 1989, at 63.

126. For example, Midland Bank of Britain, with \$1.7 billion in loans outstanding, the third largest lender to Mexico after Bank of America and Citicorp, has raised its reserves to 50% of its LDC debt portfolio of \$7 billion and will probably take the exit options and make no further loans to Mexico. *Id.*

127. See Whalen, *supra* note 1.



Another debt reduction technique is the debt-equity swap.<sup>128</sup> Soon after the world debt crisis gained public attention the legal correspondent to the *Financial Times* speculated that:

The only alternative to exposing the holes left by unpaid and unrecoverable debts in bank balances is the conversion of these debts into very long investment loans or, better still, into equity. . . .

The difficulty lies . . . [in that] there is still no satisfactory system of legal protection for foreign investments in developing countries whose regimes are unstable and whose economic policies are volatile. . . .<sup>129</sup>

The equity, of course, might be expropriated. Arbitration, as discussed earlier,<sup>130</sup> would be one preferred means for settling disputes if the alternative is the borrower's local courts, or if the sovereign immunity and act of state defenses might otherwise protect the defaulting borrower.

Swaps involve the purchase, at a discount in hard currency, of a loan by a private investor which trades it in with the debtor country for the equivalent, at face value or nearly so, in local currency of the debtor country. The local currency is then invested in a local enterprise, often a subsidiary of the foreign investor. The foreign investor thus obtains local currency at an attractive rate, based on the secondary debt market level.<sup>131</sup> The bank cashes out its questionable loan at a discount. The debtor country simultaneously reduces its external debt and encourages foreign investment.

For example, American Express Company might purchase Mexican debt at a discount and use the equivalent face value of local currency to pay the local currency bills of its credit card customers.<sup>132</sup> Conservation groups such as the World Wildlife Fund might purchase debt that is exchanged for local currency used to protect South American parks and reserves.<sup>133</sup>

The bank itself might trade its loan for an equity interest in a local enterprise in a bilateral exchange. The Federal Reserve Board has issued regulations permitting United States bank holding companies and their subsidiaries to enter into debt-equity exchanges within limits.<sup>134</sup> The Office of the Comptroller of the Currency has also set forth guidelines for such exchanges.<sup>135</sup> If banks with significant loans to sovereign

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128. See generally Note, *Debt-Equity Swapping: Reconsidering Accounting Guidelines*, 26 COLUM. J. TRANSNAT'L L. 377 (1988); Note, *International Debt: Debt to Equity Swaps*, 28 HARV. INT'L L.J. 507 (1987) [hereinafter *International Debt*]; Note, *Debt for Equity Swaps in Mexico*, 23 TEX. INT'L L. REV. 443 (1988) [hereinafter *Mexico*]; Note, *Give Me Equity or Give Me Debt*, 10 U. PA. J. INT'L BUS. L. 89 (1988). For the Chilean program, see *World Bank: Report on Chilean Debt Conversion With Chilean Rules on Investments With Foreign Debt Instruments and Provision in a Debt Restructuring Agreement for Such Investments*, 26 INT'L L. MATERIAL 819 (1987). For the Brazilian program, see generally Paes, *Brazil's Debt to Equity Swap Program*, 23 INT'L LAW. 533 (1989).

129. Hermann, *A Way to Rescue the Bankers*, *Financial Times*, Sept. 16, 1983, at 22, cols. 1-3.

130. See *supra* text accompanying notes 86-111.

131. For example, as of October 1988, Chilean debt was trading at 57% of its face value, Mexican debt at 46% of its face value, and Brazilian debt at 42% of its face value. *International Debt*, *supra* note 128.

132. See *AmexCo Seeks to Use Mexico's Debt*, *Int'l Herald Tribune*, Jan. 14, 1988, at 9, col. 2.

133. News Release of World Wildlife Federation, Dec. 14, 1977 (concerning \$1 million swap for parks in the Andes, Amazon, and Galapagos).

134. See Regulation K, 12 C.F.R. § 211.5(f) (1989).

135. See No Objection Letter 87-10, Fed. Banking L. Rep. (CCH) ¶ 84,039 (Nov. 27, 1987).

borrowers participate actively in debt-equity swaps, their accountants must mark down their portfolios to the assets' discounted value.<sup>136</sup>

For federal income tax purposes, the sale of a loan for its discounted dollar value will produce a loss to the bank. To the equity investor there will be a gain on the exchange of the debt for local currency to the extent that the currency's fair market dollar value exceeds the amount paid the bank. The basis in the foreign stock acquired with the local currency will be calculated as the amount paid to the bank plus any gain recognized on the exchange of debt for local currency.<sup>137</sup> If the bank itself engages in a swap involving a credit to an American charity for its foreign activities (such as park conservation for example), the fair market value of the local currency given to the charity will be treated as a charitable contribution.<sup>138</sup>

While such swaps have achieved some limited success, they have not significantly reduced the overall debt burden of developing countries.<sup>139</sup> Despite swaps and write-downs of loans, major commercial banks remain at risk from foreign debt exposure.<sup>140</sup>

136. Buchheit, *supra* note 117, at 411.

137. See Rev. Rul. 87-124, 1987-2 C.B. 205.

138. See Rev. Rul. 87-124 and T.D. 8192, 53 Fed. Reg. 12,006.

139. For example, Chile, the most successful at debt-equity swaps, has succeeded in cancelling \$2.5 billion, or 10% of its total foreign debt. Truelli, *Chile Pushes Debt-Conversion Program*, Wall St. J., Dec. 9, 1987, at 34, col. 1. Mexico, on the other hand, had only succeeded in cancelling \$2 billion of its \$108 billion foreign debt by the end of 1987. Riding, *Deepening Gloom Over Latin American Debt*, N.Y. Times, Dec. 28, 1987, at D8, col. 4. See also Mexico, *supra* note 128 at 461 (discussing limited success of debt-equity swaps in Latin America).

140. One source reports the following risk of major New York banks:

Money-Center Banks Most at Risk from Notice 89-58

Company Name	Average Foreign Loans as a % of Total Average Loans	Foreign Tax
		Provision as a % of Total Income Tax Provision
Bankers Trust	42%	57%
Chase Manhattan	40	64
Citicorp	35	48
Continental Bank Corp.	31	43
Manufacturers Hanover	37	31
J.P. Morgan	58	63

Pugilski, *IRS Notice Alters Loan-Loss Allocation*, BANK ADMIN., July 1989, at 10 (discussing the "sourcing" (between domestic and foreign income) of loan losses according to Rev. Notice 89-58).

A more recent estimate gives the following figures:

Degrees of exposure

	Medium- and long-term third world loans (in millions)	Reserve against third world loans (in millions)	Reserve as percentage of loans
Citicorp	\$8,854	\$2,600	30%
BankAmerica	7,400	2,460	33
Manufacturers Hanover	6,800	2,400	36
Chase Manhattan	6,400	3,000	46
Chemical Banking	4,600	1,246	27
Bankers Trust	3,110	995	32
J.P. Morgan	2,800	3,000	100

Bartlett, *supra* note 1.

## III. PROBLEMATIC DEPOSITS: BANKS AS TRANSNATIONAL BORROWERS

A. *Capital Flight, Anonymity, and Taxes*

Capital flight and the debt crisis are part and parcel of the same sad saga. The economic difficulties of debtor nations that have borrowed in harder foreign currencies must be understood in the context of the capital flight that plagues developing countries. The repayment of cross-border loans is problematic in large measure because so much of the money lent to lesser developed countries flows out again to be deposited in Western banks, often in so-called "haven" countries. One commentator has summarized the linkage this way:

In some cases, the wealthiest classes of poor countries have actually sent more money out of their countries than foreign borrowing has brought in—and often it's the same money. American banks have promoted, and profited from, both sides of the transaction. Sometimes the money never leaves the United States. The entire cycle is completed with a few book-keeping entries in New York.<sup>141</sup>

According to one estimate, the foreign assets of nonbank private residents of the fifteen biggest debtor countries amount to more than half their total foreign debt, or over \$300 billion.<sup>142</sup> It has been estimated that Mexico sent out half of the nearly \$100 billion borrowed between 1974 and 1985, with Argentina sending out 60% and Venezuela 100%.<sup>143</sup> The problem is not so much that developing countries do not have assets, but that their assets are largely in foreign banks.

Corruption among politicians and bureaucrats of developing countries does not help matters.<sup>144</sup> The deposed Philippine President Ferdinand Marcos reportedly amassed a personal fortune estimated at \$ 1.5 billion on an annual salary of less than \$50,000.<sup>145</sup> Ex-President Jean-Claude Duvalier of Haiti was suspected of similarly looting his country.<sup>146</sup> Both affairs raised sovereign immunity issues similar to those discussed in the first part of this paper.

There is little consensus concerning the definition of capital flight. We refer to "foreign investment" by Americans, Japanese and Kuwaitis, but to the "capital

141. Henry, *supra* note 2, at 20.

142. *Brady's Fading Plan*, THE ECONOMIST, Aug. 12, 1989, at 16 (quoting estimates by economists at J.P. Morgan). For an empirical statistical country by country breakdown of external debt, capital flight and balance of payments for some of the major debtor nations, see CAPITAL FLIGHT AND THIRD WORLD DEBT 37-42 (D. Lessard & J. Williamson eds. 1987) [hereinafter CAPITAL FLIGHT]. See also I. WALTER, *supra* note 2, at 42-43.

143. Henry, *supra* note 2, at 20.

144. See Reisman, *Harnessing International Law to Restrain and Recapture Indigenous Spoliations*, 83 AM. J. INT'L L. 56 (1988).

145. See *Republic of the Philippines v. Marcos*, 818 F.2d 1473, 1476 (9th Cir. 1987). The complaint in the case alleges conversion of \$1.55 billion belonging to the Filipino government and its citizens, most of which allegedly went into Swiss bank accounts. Allegedly \$4 million went into real estate in Beverly Hills and \$7 million went into property located in Hawaii. Note, *Marcos Mania: The Crusade to Return Marcos' Billions To The Philippines Through the Federal Courts*, 18 RUTGERS L.J. 217 (1986). On the Marcos litigation, see Note, *Ferdinand Marcos and the Act of State Doctrine*, 13 J. INT'L L. & TREATY 127 (1988). Note, *Ex-Head of State Immunity: A Proposed Statutory Tool of Foreign Policy*, 97 YALE L.J. 299 (1987).

146. See Judgment of Apr. 25, 1989, Cour d'Appel Aix-en-Provence, France (No. 343/1988) (quoting Haiti and its fallen dictator Duvalier).

flight" of Latin Americans and Africans.<sup>147</sup> The "flight" component dominates our perception of the phenomenon that money runs away from the high inflation, heavy taxation, and political instability of developing countries, toward the lower inflation, greater political stability, and in some cases lower taxation, of hard-currency denominated assets in industrialized haven countries.

That developing country assets end up in the industrialized nations reflects a desire for a greater security and reduced erosion of assets. The political and economic risks of expropriation and hyper-inflation in Europe in the 1930's and in many of the developing countries after the Second World War has served as a caution to many not blessed with the relative stability known in the United States. The instability of much of the world makes "anonymity" imperative for many. Thus a Swiss or Luxembourg bank account may serve as a modern-day "city of refuge."<sup>148</sup>

The problem is not just with the economies and politics of the source countries, however. Legal and fiscal policies of haven countries also play a role. In particular, bank secrecy laws and favorable tax regimes are instrumental to the attraction of foreign deposits by developed-country banks.

To understand the demand for secrecy in international banking, one must remember that the priorities of developing country depositors include the avoidance of exchange controls and punitive tax policies in the country of their residence. The risk of getting caught in the illegal export of capital is outside the experience of most Americans. Confidentiality in the destination country tends to reduce this risk and thus to increase the deposit's attractiveness. Some economists even claim that "it is possible to map out the trade-offs between confidentiality, risk and expected returns using a standard analytical framework."<sup>149</sup>

The United States has implicitly accepted this concern for confidentiality by tailoring its tax regulations to permit foreigners to invest in American assets through the screen of a financial institution in a banking secrecy haven.<sup>150</sup> Indeed, one abiding conflict *within* United States national policy remains the need to preserve anonymity as an option for foreign investors while preventing its use to facilitate violations of American tax and insider trading law, or the laundering of illicit drug money.

Investors from abroad can often take advantage of tax regimes designed to attract foreign capital.<sup>151</sup> For example, the United States has eliminated income taxation of bank account interest paid to nonresident aliens,<sup>152</sup> bond interest paid to nonresident aliens,<sup>153</sup> and capital gains on securities.<sup>154</sup> Switzerland's "fiduciary deposit" (*dépôt*

147. See generally CAPITAL FLIGHT, *supra* note 142.

148. See Numbers 35:11-12; Joshua 20:2. The analogy to the Biblical "city of refuge" is admittedly strained, since the Biblical refuge was intended to deal with reprisals against involuntary manslaughter. See M. ELON, PRINCIPLES OF JEWISH LAW 531 (1975).

149. Walter, *supra* note 2, at 103, 105.

150. See, e.g., Treas. Regs. 35a9999-5 (1989). See generally, Park, *American Income Tax Aspects of Trans-Border Securities Investments*, *supra* note 9.

151. I.R.C. § 871(i) (1988). See generally McLure, *U.S. Tax Laws and Capital Flight from Latin America*, 20 INTER-AM. L. REV. 321 (1989).

152. I.R.C. § 871(h) (1988).

153. I.R.C. § 871(h) (1988) (*re* "portfolio debt" instruments).

154. See the "safe harbor" rules of I.R.C. § 864(b)(2) (1988).

*fiduciaire*) accomplishes the same end of not taxing foreigners on interest from Swiss bank accounts.<sup>155</sup>

### B. Bank Secrecy<sup>156</sup>

The anonymity offered by bank secrecy has benefited a varied class of depositors: victims of Nazi persecution seeking refuge for their assets, the garden-variety French and Italian businessmen looking for relief from their tax inspectors, and less savory characters such as money launderers and corrupt dictators.<sup>157</sup>

Bank secrecy does not always marry well with the interests of the allies and trading partners of the haven country. Thus measures to breach foreign bank confidentiality are the logical extension of the American interest in enforcing economic regulations designed to insure the integrity of its securities market and tax system.

The interests of our foreign friends, however, are no less important. Efforts to sidestep confidentiality in the context of American judicial and administrative investigations have been problematic for financial centers where private banking represents an important part of the national economy and work force. Switzerland in particular has a bank secrecy law that is perceived by some bankers, both inside and outside of Switzerland, as vital to the prosperity of Swiss financial institutions.

Switzerland's importance in international finance cannot be attributed exclusively to its secrecy laws. However, it would be disingenuous to claim that secrecy is not a factor. One advantage of Switzerland over its chief European rival in private banking is that the advancing integration of the European Economic Community creates the risk that Luxembourg will be forced to compromise its banking secrecy<sup>158</sup> by sharing information with other EEC members.

Essentially, Swiss bank secrecy covers the identity of the customers and the details of their relationships. It is subject to a number of exceptions, the most important of which is that it may be lifted in the context of judicial investigations, including non-Swiss proceedings. Although banking secrecy<sup>159</sup> is also required in-

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155. The theory here is that a Swiss bank acts as a customer's agent in placing his money with a foreign bank in a tax haven from which interest can be paid free of tax, the banking relationship existing directly between the foreign customer and the foreign bank.

156. For a most extensive discussion of the interaction of bank secrecy and capital flight, see I. WALTER, *supra* note 2. See also White, *Principles of Confidentiality in Cross-Border Banking*, in *LEGAL ISSUES IN CROSS-BORDER BANKING* 9-22 (R. Cranston ed. 1989).

157. See *id.* See also Nadelman, *Unlaundering Dirty Money Abroad*, 18 *INTER-AM. L. REV.* 33 (1986).

158. The Luxembourg Penal Code states:

Physicians, surgeons, health officers, pharmacists, mid-wives and all other persons to whom, by reason of their position or profession, secrets have been confided, and who reveal such secrets in cases other than those in which they are called to testify in court and in those in which the law compels their disclosure, shall be punishable by imprisonment from eight days to six months and a fine from 100 to 500 francs.

PENAL CODE art. 458 (Luxembourg). For cases in which the banking secrecy of Luxembourg was used to cover criminal activity, see *Crime and Secrecy: The Use of Offshore Banks and Companies*, S. Rep. No. 130, 99th Congress, 1st Sess. 94-95 (1985).

159. See M. AUBERT, J.-P. KERNEN & H. SCHÉNLE, *LE SECRET BANCAIRE SUISSE* (1982). See also Aubert, *The Limits of Swiss Banking Secrecy*, *J. INT'L TAX & BUS. LAW.* (Boalt) 273 (1984); Dunant & Wassmer, *Swiss Bank Secrecy: Its Limits Under Swiss and International Laws*, 20 *CASE W. RES. J. INT'L L.* 541 (1988).

directly by the Code of Obligations,<sup>160</sup> it is the Federal Banking Law of 1934 that imposes the most explicit criminal penalties for the breach of bank secrecy.

Article 47 of the Federal Banking Law translates as follows:

- 1) Any person who in his capacity as a member of the governing body, employee, [or] agent . . . of a bank, reveals a secret confided to him or which he knew by reason of his position or employment, or any person who induces another to violate professional secrecy shall be imprisoned for not longer than six months or shall be fined not more than fifty thousand francs.
- 2) If the offender acted negligently, the penalty is a fine of not more than thirty thousand francs.
- 3) Breach of secrecy remains punishable even after the holder of the secret has ended his employment or mission, or has stopped his professional activity.
- 4) The provisions of federal and cantonal legislation concerning the duty to give information to authorities and to testify in litigation are not affected.<sup>161</sup>

Article 273 of the Criminal Code has a similar effect by prohibiting the disclosure of manufacturing or business secrets to foreign officials.<sup>162</sup> Apart from the penalties provided in the Federal Banking Law and the Criminal Code, the banker and the bank are civilly liable for a breach of secrecy and the bank risks the loss of its license.

Swiss banking secrecy is not absolute. In some cantons, a Swiss banker may be obliged to testify in Swiss civil proceedings without regard to confidentiality. Bankers are obliged to testify in Swiss criminal cases, on the theory that public law and the public interest preempt the private interest in bank secrecy.

Swiss bank secrecy is problematic in the context of international banking supervision. To consolidate the total risks of the banking group as a whole, regulatory authorities in the country of the parent bank need to know whether borrowers from foreign subsidiaries are also borrowers from the parent bank. There is some authority

160. Swiss law requires the "faithful and careful performance" (author's translation) of the banker's mandate, including the obligation of confidentiality. CODE DES OBLIGATIONS [Co.] § 398 (Switz.).

161. Author's translation. The French original of Article 47 reads as follows:

1. Celui qui, en sa qualité de membre d'un organe, d'employé, de mandataire, de liquidateur ou de commissaire de la banque, d'observateur de la Commission des banques, ou encore de membre d'un organe ou d'employé d'une institution de revision agréé, aura révélé un secret à lui confié ou dont il avait eu connaissance à raison de sa charge ou de son emploi, celui qui aura incité autrui à violer le secret professionnel, sera puni de l'emprisonnement pour six mois au plus ou de l'amende jusqu'à concurrence de 50 000 francs.

2. Si le délinquant a agi par négligence, la peine sera l'amende jusqu'à concurrence de 30 000 francs.

3. La violation du secret demeure punissable alors même que la charge ou l'emploi a pris fin ou que le détenteur du secret n'exerce plus sa profession.

4. Sont réservées les dispositions de la législation fédérale et cantonale statuant l'obligation de renseigner l'autorité et de témoigner en justice.

Loi fédérale sur les banques art. 47 (Switz).

162. Article 273:

Whoever makes available a manufacturing or business secret to a foreign governmental agency or a foreign organization or private enterprise or to an agent of any of them, shall be subject to imprisonment and in grave cases to imprisonment in a penitentiary. The imprisonment may be combined with a fine.

The French original reads:

Celui qui aura cherché à découvrir un secret de fabrication ou d'affaires pour le rendre accessible à un organisme officiel ou privé étranger, ou à une entreprise privée étrangère, ou à leurs agents, celui qui aura rendu accessible un secret de fabrication ou d'affaires à un organisme officiel ou privé étranger, ou à une entreprise privée étrangère, ou à leurs agents, sera puni de l'emprisonnement ou, dans les cas graves, de la réclusion. Le juge pourra en outre prononcer l'amende.

CODE PENAL [Cp] art. 273 (Switz.).

that Swiss supervisors have accepted the legitimacy of subsidiary disclosure of selected information to the parent when absolutely necessary for the supervision of consolidated loans to one debtor.<sup>163</sup>

Despite their deserved reputation for protecting financial privacy, the Swiss recently have become more open to requests to lift secrecy in the context of international judicial assistance.<sup>164</sup> They are parties to a European Convention on Judicial Assistance<sup>165</sup> and the United States-Swiss Treaty on Mutual Assistance in Criminal Matters.<sup>166</sup> The latter Treaty gives American authorities the opportunity for access to information otherwise covered by banking secrecy.<sup>167</sup> In the first six years of its operation, the United States reportedly availed itself of the treaty over two hundred times while the Swiss made sixty-five requests.<sup>168</sup>

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163. See letter from the Federal Banking Commission to the Association of Foreign Banks in Switzerland dated December 3, 1984. The letter assumes that the customer will have agreed to disclosure.

German original:

Informationen über einzelne Kunden sollen zudem einzig dann erteilt werden, wenn aufsichtsrechtlich zwingende Gründe vorliegen und im Ausland die ausschliessliche Verwendung für Zwecke der Bankenaufsicht gewährleistet ist. Im Vordergrund steht hier das Aktivgeschäft, insbesondere die Meldung von grösseren Schuldnern im Hinblick auf die konsolidierte Überwachung von Klumpenrisiken, während in der Regel kein aufsichtsrechtliches Bedürfnis an Angaben über einzelne Gläubiger oder Kunden des indifferenten Geschäfts der Tochterbank besteht.

French version:

Les renseignements concernant des clients ne pourront, en outre, être fournis qu'ensuite de raisons impératives ayant trait à la surveillance d'une part et, d'autre part, que si l'assurance est donnée par l'étranger de n'utiliser les renseignements qu'à des fins de surveillance bancaire exclusivement. Dans ce contexte, l'accent est mis sur les opérations actives et, plus particulièrement sur l'annonce de débiteurs importants eu égard à la surveillance consolidée des gros risques; dans un contexte plus général, nul besoin de surveillance consolidée des gros risques; dans un contexte plus général nul besoin de surveillance de données s'impose quant aux créanciers ou clients particuliers en matière d'opérations indifférentes de la filiale.

English translation:

Information concerning individual clients is therefore to be divulged only if imperative reasons relating to the right of supervision make this necessary and provided a guarantee is given from abroad that the information provided will be used exclusively for the purpose of banking supervision. In this connection, emphasis is placed on lending and investment business and, in particular, on the reporting of relatively big borrowers with a view to the consolidated supervision of aggregated risks; as a rule, no need related to the right of supervision exists in respect of information concerning the non-credit business with creditors or clients of the subsidiary bank.

*Id.*

164. *Crime and Secrecy: The Use of Offshore Banks and Companies*, S. Rep. No. 130, 99th Congress, 1st Sess. 49 (1985).

165. European Convention on Mutual Assistance in Criminal Matters, *opened for signature*, Apr. 20, 1959, 472 U.N.T.S. 185.

166. Treaty on Mutual Assistance in Criminal Matters, *signed* May 25, 1973, United States-Switzerland, 27 U.S.T.S. 2019, T.I.A.S. No. 8302 [hereinafter Mutual Assistance Treaty].

167. The treaty provides:

The Swiss Central Authority shall, to the extent that a right to refuse to give testimony or produce evidence is not established, provide evidence or information which would disclose facts which a bank is required to keep secret or are manufacturing or business secrets, and which affect a person who, according to the request, appears not to be connected in any way with the offense which is the basis of the request, only under the following conditions:

- a. the request concerns the investigation or prosecution of a serious offense;
- b. the disclosure is of importance for obtaining or proving facts which are of substantial significance for the investigation or proceeding; and
- c. reasonable but unsuccessful efforts have been made in the United States to obtain the evidence or information in other ways.

*Id.*, art. 10 § 2.

168. Knapp, *Mutual Legal Assistance Treaties as a Way To Pierce Bank Secrecy*, 20 CASE W. RES. J. INT'L L. 405, 414 (1988).

## 1. Insider Trading

Investigation of "insider trading" in the American securities markets represents one of the most fertile grounds for judicial assistance.<sup>169</sup> However, the Swiss-American Mutual Judicial Assistance Treaty did not initially cover insider trading offenses. Generally, the Treaty requires "double criminality": the offense being investigated must be a crime in both countries, or be listed on a schedule of offenses for which "compulsory measures," including the lifting of bank secrecy, are available.<sup>170</sup> But until 1988 Swiss law did not treat insider trading as a crime.

This defect in the Treaty was highlighted when the Americans requested assistance with respect to insider trading during the takeover of Santa Fe International by Kuwait Petroleum Corporation.<sup>171</sup> The Swiss Supreme Court held that the double criminality requirement was not satisfied and blocked the request.<sup>172</sup> In such circumstances, the only way to activate compulsory measures under the Treaty was to find another offense that was violated by the inside trading—for example, employee disloyalty in providing inside information to a tippee.<sup>173</sup>

This anomaly was remedied in 1982 with the signing of a Memorandum of Understanding between the United States and Switzerland,<sup>174</sup> supplemented by an agreement between Swiss banks and the Swiss Bankers' Association allowing for the disclosure of information in insider trading cases.<sup>175</sup> Since that time, cooperation between American and Swiss authorities has been such that some Swiss attorneys complain that Switzerland has gone "too far in its willingness to please foreign countries."<sup>176</sup> In 1988, an amendment to the Swiss Criminal Code became effective to prohibit insider trading explicitly,<sup>177</sup> thereby satisfying the double criminality

169. See generally P. NEYROUD, *MUTUAL ASSISTANCE IN INSIDER DEALING* (Int'l Bar Ass'n Strasbourg 1989); Hawes, Lee & Robert, *Insider Trading Law Developments: An International Analysis*, 14 L. & POL'Y INT'L BUS. 335 (1982).

170. Mutual Assistance Treaty, *supra* note 166, art. 4, attached schedule; Judgment of Jan. 26, 1983, Tribunal fédéral, Switz., 109 A.T.F. 1b 47 [hereinafter *Santa Fe I*].

171. *Santa Fe I*.

172. The request was later modified to describe the offenses under investigation as analogous to Code Pénal art. 162 (Switz.). On *Santa Fe II*, see *Operations d'initiés: Entraide judiciaire pour les Etats-Unis*, Journal de Genève, May 17, 1984, at 7, col. 4; Wall St. J. Europe, Aug. 19, 1983, at 2, col. 3. The *Santa Fe* case is reprinted in 28 CENTRE D'ETUDES JURIDIQUES EUROPEENNES, FACULTE DE DROIT DE GENÈVE, COLLOQUE INTERNATIONAL: L'AVANT PROJET DE LOI FEDÉRALE SUR LES OPERATIONS D'INITIÉS 300 (1984).

173. See CODE PÉNAL [Cp] art. 162 (Switz.):

Celui qui aura révélé un secret de fabrication ou un secret commercial qu'il était tenu de garder en vertu d'une obligation légale ou contractuelle, celui qui aura mis à profit cette révélation, sera, sur plainte, puni de l'emprisonnement ou de l'amende.

*Id.*

174. Memorandum of Understanding to Establish Mutually Acceptable Means for Improving International Law Enforcement Cooperation in the Field of Insider Trading, Aug. 31, 1982, United States-Switzerland, reprinted in 22 INT'L LEGAL MATERIALS 1 (1983). See generally P. HONEGGER, *AMERIKANISCHE OFFENLEGUNGSPFLICHTEN IN KONFLIKT MIT SCHWEIZERISCHEN GEHEIMHALTUNGSPFLICHTEN* (1986). See also Honegger, *Demystification of the Swiss Banking Secrecy and Illumination of the United States-Swiss Memorandum of Understanding*, 9 N.C.J. INT'L L. & COM. REG. 1 (1984).

175. Swiss Bankers' Association Agreement with Regard to the Handling of Requests for Information from the Securities Exchange Commission (SEC) on the Subject of Misuse of Insider Information of Aug. 31, 1982, reprinted in 22 INT'L L. MATERIALS 7 (1983).

176. Dunant & Wassmer, *supra* note 159, at 575. The authors quote the Swiss Justice Minister who reported that the Swiss acquiesced to all American requests in 1987. *Id.* Of course, this is probably because the Americans screen out unjustifiable requests before they leave the Justice Department.

177. Cp art. 161 (Switz.) entered into force July 1, 1988. The author's translation of the French version follows:



requirement of the Mutual Assistance Treaty<sup>178</sup> and rendering both the 1982 Memorandum of Understanding and the Swiss Bankers' Association Agreement superfluous.

## 2. Tax Evasion<sup>179</sup>

Tax evasion is another offense frequently facilitated by bank secrecy. The Mutual Judicial Assistance Treaty, however, is generally inapplicable to tax offenses, except in the context of investigations or prosecutions of Mafia figures.<sup>180</sup> The investigation must aim at persons reasonably suspected of belonging to the upper echelon of organized crime.<sup>181</sup>

The Swiss have also have implemented an internal (*i.e.*, nontreaty-related) statute on judicial assistance.<sup>182</sup> Characterization of the offense being investigated is critical to the use of this statute. Like the Treaty, the law excludes from its scope requests relating to tax offenses<sup>183</sup> except for a narrow category of complex tax fraud: *escroquerie* (or in German *Betrug*). *Escroquerie* results from what the law terms a "clever posture"—*attitude astucieuse*. The intentional falsification of supporting documents filed with a return (a balance sheet containing the erasure of a zero at the end, for example) would constitute an *attitude astucieuse*, while a mere failure to file would not.

The concept of "cleverness" or *astuce* in itself is of little help to the dialogue. *Astucieux* translates as "artful" or "cunning" or "tricky" or "clever"—yet there is

### Exploitation of confidential knowledge

1. A member of the board of directors, the management or the auditors or an agent of a stock company or of a company controlling or being controlled by a stock company, a member of a governmental body or a public official, an assistant of the aforementioned persons, who procures a pecuniary benefit for himself or for another by exploiting or conveying to another his knowledge of confidential information which, if and when publicized, can be expected to materially influence the price of shares, of other securities or of options traded on a Swiss stock exchange, is subject to imprisonment or fine.

2. The recipient of information obtained from an insider as defined under paragraph 1 above who procures a pecuniary benefit for himself or for another by exploiting this information is subject to imprisonment of up to one year or to a fine.

3. Confidential information within the meaning of paragraphs 1 and 2 above includes an impending issue of rights of participation, a merger or a similar event of comparable significance.

4. In case of a merger of two stock companies, paragraphs 1 to 3 apply to both companies.

5. Paragraphs 1 to 4 apply accordingly in the event that the exploitation of confidential information relates to participation certificates, other securities, debentures or options of a cooperative society or a foreign corporation.

Author's translation of C<sub>F</sub> art. 161 (Switz.).

178. Mutual Assistance Treaty, *supra* note 166. See Lombardini, *Swiss Stock Exchanges: What Does the Future Hold?*, 8 INT'L FIN. L. REV. 33 (1989).

179. See generally, Brown, *Allowing Tax Laws to Cross Borders to Defeat International Tax Avoidance: The Convention on Mutual Administrative Assistance in Tax Matters*, 15 BROOKLYN J. INT'L L. 59 (1989); Connick & Roth, *Subpoenas of Overseas Bank Records: Getting Out of the Middle—A Message to Bank Counsel*, 9 N.Y. L. SCH. J. INT'L & COMP. L. 131 (1988); Frei, *Overcoming Bank Secrecy: Assistance in Tax Matters in Switzerland on Behalf of Foreign Criminal Authorities*, 9 N.Y. L. SCH. J. INT'L & COMP. L. 107 (1988); Granwell & Desirgh, *International Fiscal Cooperation in Exchanges of Information: The United States Perspective*, 4 STRATEGY IN INT'L TAX'N 173 (1989).

180. Mutual Assistance Treaty, *supra* note 166, art. 2(1)(c)(5) and arts. 6 & 7.

181. *Id.* art. 2(2)(a) & art. 6. Other conditions for judicial assistance in tax matters involving organized crime figures include: (1) the evidence of crimes committed is insufficient to constitute proof of the crime, (a requirement intended to prevent unnecessary requests for tax information), (2) the organized crime figure could be put in jail for a period of time long enough to inflict serious harm on the group, and (3) the securing of the information or evidence would be impossible, or unduly burdensome, without the assistance of the other state. *Id.* arts. 7(2) & (3).

182. Loi Sur L'Entraide Internationale En Matière Pénale, 20 March 1981, entry Into force, 1 Jan. 1983.

183. *Id.* art. 3.

obviously a requirement of something more than cleverness in an American sense. The idea seems to be that a fraud is not *astucieuse* if the person defrauded could have avoided being defrauded by reasonable care. The document changed must have some juridical value other than as an information return in the case at hand. For example, a balance sheet, or the employer's statement of the employee's salary, has such a juridical value. The forgery of an employer's signature would be an *escroquerie*, as would a fake invoice for services or goods.

The closest American tax law analogue of *escroquerie* may be the willful making of a false statement under penalty of perjury.<sup>184</sup> On the other hand, a "willful failure to file a return or supply information" would probably not constitute *escroquerie*. There must be a forged or "doctored" document, or intentionally falsified accounts to constitute *escroquerie*.

Article XVI of the Income Tax Treaty provides<sup>185</sup> for an exchange of information between the tax administrations of the two countries. However, the treaty expressly excludes from its coverage the exchange of any information that would disclose "any trade, business, industrial or professional secret."<sup>186</sup> This covers bank secrecy and the attorney-client privilege. Thus, if the information is unobtainable under local law, it will probably not be obtainable under the Treaty. The only exception to the protection of secrecy seems to be the case where fraud is committed by a U.S. citizen or resident against the Internal Revenue Service. Language in the treaty permits exchange of information "as is necessary . . . for the prevention of fraud" in relation to taxes covered by the treaty.<sup>187</sup> This would seem to cover the case of American tax cheats. It is not certain (at least to this author) what sort of "fraud" (complex *escroquerie* or simple American-style fraud) is covered.

### 3. *Convention de Diligence*

In at least one way, Swiss efforts to prevent bank secrecy from being used to facilitate serious crimes are more far-reaching than American measures. Members of the Swiss Bankers' Association agreed to what is commonly called the "Convention de Diligence" (CDB) translated as "Agreement on the Swiss Banks' Code of Conduct with regard to the Exercise of Due Diligence."<sup>188</sup> The heart of the Convention de Diligence is the "know your customer" rule. To preserve the reputation of the Swiss banking community and to ensure ethical conduct when accepting funds, the banks agree:

- a) to verify the identity of their contracting partners and, in cases of doubt, to obtain from the contracting partner a declaration setting forth the identity of the beneficial owner to whom the assets entrusted to the bank belong;
- b) not to provide any active assistance in the flight of capital;

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184. Punishable under I.R.C. § 7206 (1988).

185. United States-Switzerland Income Tax Treaty, May 24, 1951, art. 26, 2 U.S.T.S. 1751, 1760 T.I.A.S. No. 2316.

186. *Id.*

187. *Id.*

188. Copies of the Agreement with the most recent amendments dating from July 1, 1987, are available in translation from the Swiss Bankers' Association. The Agreement is called hereinafter "Convention de Diligence."

c) not to provide any active assistance in cases of tax evasion or similar acts, by delivering incomplete or misleading attestations.<sup>189</sup>

Banks are generally required to verify the ultimate beneficial owner of accounts held by shell companies (*sociétés de domicile*). A *société de domicile* is defined to include Swiss and foreign enterprises regardless of their function or registered office, provided

a) they do not have their own premises (i.e., they are domiciled c/o an attorney, a trust company, a bank, etc.), or b) they do not have their own staff working exclusively for them, or their own staff engages solely in administrative tasks (bookkeeping and correspondence under instructions issued by individuals or companies controlling the domiciliary company).<sup>190</sup>

By knowing its customers, the Swiss banking community will be able to distinguish the use of secrecy to protect two different types of criminal activity: (1) acts condemned by most of the world community—drug running, money laundering, and illegal arms dealing; and (2) what might be termed normal capital flight: the Italian businessman not paying his full share of taxes, or the traumatized immigrant trying to prepare a financial “city of refuge”<sup>191</sup> if things go as bad in his new home in Latin America as they did in his old home in Europe or the Middle East.

In some cases accounts are opened not by the customer, but by a lawyer or accountant bound by professional confidentiality acting on behalf of a client. The Convention de Diligence requires that such lawyers and fiduciaries confirm to the bank that they know the identity of the beneficial owner of the account. For example, the lawyer and accountant must know that “No-Tell Fabric Company S.A. of Panama” is ultimately owned by Mrs. Christine Park of Quakertown. Having displayed due diligence, they must further confirm that they are not aware of any fact that might indicate that the customer is abusing the right to banking secrecy, or that the assets concerned are the fruit of any criminal activity.<sup>192</sup> The professional relationship may not be transitory, nor “aimed primarily at concealing the name of the beneficial owner from the bank.”<sup>193</sup>

The Convention de Diligence also provides that Swiss banks may not provide any “active assistance” in transferring capital outside countries whose laws impose restrictions on the placing of funds abroad.<sup>194</sup> The customer must supply his own suitcase to carry the money across the border.

189. *Id.* art. 1.

190. See Convention de Diligence, *supra* note 188. This report is made on “Form A.”

191. See *supra* note 148.

192. Convention de Diligence, *supra* note 188, art. 5, § 2.

193. *Id.*

194. *Id.* art. 6. In the annotation to art. 6, the Swiss Bankers Association defines “active assistance” as follows:

- a) receiving clients abroad by appointment outside the bank’s own premises, for the purpose of accepting funds;
- b) participation abroad in the setting up of offset transactions when the bank knows or, based on a combination of circumstances, should know that the offset is aimed at furthering the flight of capital;
- c) active collaboration with individuals and companies that arrange for the flight of capital on behalf of third parties or who provide assistance to this effect
  - by remitting orders;
  - by promising them commissions;
  - by keeping their accounts while such individuals or companies have their domicile or registered office

The Swiss desire to present a good image is further evidenced by Swiss government measures in the Marcos affair. The Federal Council blocked the Marcos' assets in six major banks, and all Swiss banks were advised that it would be a violation of their duty of diligence to allow the withdrawal of Marcos' funds before the situation was clarified.<sup>195</sup> The initial blocking order was replaced by a provisional order when the Philippines made a request for legal assistance. The political expediency in the blocking of the Marcos' assets has attracted notice, not always favorable.<sup>196</sup>

It should be noted that when the shoe is on the other foot, and foreign investigations lead to records of American banks, the United States has been liberal in granting foreign governmental authorities access to documents of financial institutions in the United States.<sup>197</sup> American courts will assist foreign judges through letters rogatory under domestic statute<sup>198</sup> as well as under treaty.<sup>199</sup>

### C. *The Extraterritorial Reach of Orders Compelling Information*

When mutual judicial assistance is not effective, American courts have attempted to obtain disclosure of information unilaterally, generating considerable controversy concerning the "extraterritorial" effect of American law. One commentator has articulated the dilemma as follows:

[C]ourts committed to the rule of law must order acts in violation of foreign law, or thwart enforcement of domestic law, effectively surrendering sovereignty to the foreign nation. Inordinate deference to foreign law would be an invitation to expanded nefarious use of foreign banks, resulting in a hemorrhage of revenue, or a haven for the profits of illegal activities which could either conceal criminal conduct or make the possibility of detection and punishment worth the risk. Obdurate insensitivity to the laws of foreign sovereigns, and the difficult situation in which the bankers in the middle find themselves, would give rise to

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in Switzerland and the bank knows that they are using their accounts for business purposes to assist in the flight of capital;

d) referring customers to the persons and companies described in letter c).

e) Visits to customers abroad are authorized provided the officer acting on behalf of the bank does not accept any funds that may not be legally transferred, gives no advice to assist in the illegal transfer of capital, and does not participate in any offset transactions.

*Id.* art. 6.

195. The order of the Federal Council (the Cabinet) was signed in Bern on May 24, 1986, by Council President Egli. It was based on art. 102-8 of the Swiss Constitution, giving the Federal Council authority to take measures to safeguard relations with foreign countries.

196. Dunant & Wassmer, *supra* note 159, at 565. The two Swiss commentators have stated:

The attitude of the Federal Council and the Federal Banking Commission was clearly motivated by political considerations to avoid or defeat the criticism periodically voiced against Swiss bank secrecy. It is extremely difficult to foresee how the Swiss banks will be able to follow the rules set forth by the Federal Banking Commission in the Marcos case, especially to block assets prior to the filing of any request for assistance by a foreign State. It is therefore to be hoped that the Marcos case will remain unique.

*Id.*

197. For a recent case, see *Young v. Department of Justice*, 882 F.2d 633 (2d Cir. 1989) (involving a Bermuda investigation and the United States Right to Financial Privacy Act).

198. See 28 U.S.C. § 1782 (1982). See also 28 U.S.C.A. § 1781, note 7 (Convention on Taking of Evidence Abroad) (West Supp. 1989). See also *Societe Nationale v. U.S. Dist. Court, S.D. Iowa*, 482 U.S. 522 (1987).

199. See, e.g., *United States v. Manufacturers and Traders Trust Company*, 703 F.2d 47 (2d Cir. 1987); *United States v. Lincoln First Bank*, [1980-1] U.S. Tax Cas. (CCH) at ¶ 9231. See also *United States v. Stuart*, 109 S. Ct. 1183 (1989).

charges of arrogance and scorn for solemn pronouncements on the sanctity of the "rule of law."<sup>200</sup>

An early Supreme Court decision on the production of documents held in secrecy havens was *Société Internationale pour Participations Industrielles et Commerciales S.A. v. Rogers*<sup>201</sup> better known as the "Interhandel" case, following the Swiss company's German name. A Swiss company sued the U.S. Attorney General for the return of assets seized from it during the Second World War pursuant to the Trading With the Enemy Act.<sup>202</sup> Interhandel alleged that when the assets were seized it was not an "enemy," in that its capital was not controlled by Germans. The United States government moved<sup>203</sup> for an order requiring Interhandel to produce certain documents concerning its ultimate beneficial owners, who might have invested through the screen of Swiss banks holding the Interhandel shares as nominees for Germans. The District Court had granted the government's motion to dismiss the action because of noncompliance with the discovery order.<sup>204</sup>

The Supreme Court held that Swiss secrecy law and the interdiction by the Swiss authorities made dismissal an inappropriate sanction in the circumstances. "[F]ailure to comply [with the request for documents] has been due to inability," the Court concluded, "and not to willfulness, bad faith, or any fault of petitioner."<sup>205</sup> The Interhandel case is often cited for the proposition that a good faith effort to comply with a request for documents will constitute a defense to an order for extraterritorial discovery in violation of foreign secrecy laws.

Since the Interhandel case, more than one court decision has dealt with the extraterritorial reach of federal court orders compelling production of documents in secrecy jurisdictions.<sup>206</sup> One early decision applied a comity approach and refused to order compliance with discovery orders or subpoenas that would force a party to violate a foreign law.<sup>207</sup> With the adoption of the *Restatement (Second) of Foreign Relations Law* in 1965, courts more frequently applied a balancing test.<sup>208</sup> The first significant

200. O'Donnell, *The Secrets of Foreign Bankers and the Federal Investigation: Tottering Balances*, 20 CASE W. RES. J. INT'L L. 509, 513 (1988) (footnotes omitted).

201. 357 U.S. 197 (1958).

202. 50 U.S.C. app. § 9(a) (1982). See *Société Internationale*, 357 U.S. at 198-99.

203. Pursuant to FED. R. CIV. P. 34.

204. *Société Internationale*, 357 U.S. at 200.

205. *Id.* at 212.

206. *In re Sealed Case*, 825 F.2d 494 (D.C. Cir.), *cert. denied sub nom.*, *Roe v. United States*, 484 U.S. 963, (1987); *United States v. Bank of Nova Scotia*, 740 F.2d 817 (11th Cir. 1984), *cert. denied*, 469 U.S. 1106 (1985); *United States v. Bank of Nova Scotia*, 691 F.2d 1384 (11th Cir. 1982), *cert. denied*, 462 U.S. 1119 (1986); *United States v. Vetco, Inc.*, 644 F.2d 1324 (9th Cir.), *modified*, 691 F.2d 1281 (9th Cir. 1981), *cert. denied*, 454 U.S. 1098 (1981); *United States v. Field*, 532 F.2d 404 (5th Cir.), *cert. denied*, 429 U.S. 940 (1976).

207. *Ings v. Ferguson*, 282 F.2d 149 (2d Cir. 1960).

208. RESTATEMENT (SECOND) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 40 (1965). Section 40 states: Limitations on Exercise of Enforcement Jurisdiction Where two states have jurisdiction to prescribe and enforce rules of law and the rules they may prescribe require inconsistent conduct upon the part of a person, each state is required by international law to consider, in good faith, moderating the exercise of its enforcement jurisdiction, in the light of such factors as

(a) vital national interests of each of the states,

(b) the extent and the nature of the hardship that inconsistent enforcement actions would impose upon the person,

(c) the extent to which the required conduct is to take place in the territory of the other state,

decision to apply the balancing test was *United States v. First National City Bank*,<sup>209</sup> where the court held that the conflict between German banking secrecy and American antitrust law was no excuse for failure to comply with a discovery order.

In a more recent decision, *S.E.C. v. Banca Della Svizzera Italiana*,<sup>210</sup> the Southern District of New York combined the *Restatement's* balancing test with the good faith test of the *Interhandel* case. The S.E.C. requested discovery in connection with an investigation of insider trading in the "St. Joe Minerals" affair. The court granted an order to produce documents of the Swiss institution through which the insider trading was allegedly done, finding that the bank had acted in bad faith.<sup>211</sup> Judge Pollack wrote that the bank "made deliberate use of Swiss nondisclosure law to evade, in commercial transaction for profit to it, the strictures of American securities law against insider trading."<sup>212</sup> He continued:

Whether acting solely as an agent or also as a principal (something which can only be clarified through disclosure of the requested information), BSI invaded American securities markets and profited in some measure thereby. It cannot rely on Swiss nondisclosure law to shield this activity.<sup>213</sup>

In a well-publicized 1979 uranium antitrust case<sup>214</sup> Westinghouse sought to compel documents from foreign uranium producers. The court settled on the strength of the American interest as the only pertinent inquiry.<sup>215</sup> The District Court evaluated the problematic task of balancing contradictory and mutually negating interests in such a case:

Aside from the fact that the judiciary has little expertise, or perhaps even authority, to evaluate the economic and social policies of a foreign country, such a balancing test is

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- (d) the nationality of the person, and
  - (e) the extent to which enforcement by action of either state can reasonably be expected to achieve compliance with the rule prescribed by that state.

*Id.*

209. 396 F.2d 897, 902-05 (2d Cir. 1968).

210. 92 F.R.D. 111 (S.D.N.Y. 1981).

211. *Id.* at 119.

212. *Id.* at 117.

213. *Id.* It should be noted, however, that the Supreme Court in *Societe Internationale* had considered the bad faith test when it was deciding whether the sanction of dismissing *Interhandel's* action was appropriate. The court in *Banca Della Svizzera Italiana* applied the test to the question of whether the discovery order should be issued and decided the sanction issue simultaneously.

In two *Bank of Nova Scotia* cases, the Eleventh Circuit also applied the bad faith test with the *Restatement (Second's)* balancing test in determining the appropriateness of the sanctions applied to the custodian bank—a fine of \$25,000 a day which eventually totaled \$1,825,000. *United States v. Bank of Nova Scotia*, 740 F.2d 817, 819, 821 (11th Cir. 1984), *cert. denied*, 469 U.S. 1106 (1985). This mode of analysis stacks the cards against the custodian of documents who is bound by bank secrecy, for it invariably balances away the custodian's ostensible good faith efforts to reconcile conflicting legal rules by asserting the United States' superior interests in the enforcement of its laws. See Note, *Court Ordered Violations of Foreign Bank Secrecy and Blocking Laws: Solving the Extraterritorial Dilemma*, 1988 U. ILL. L. REV. 563, 591-93. For example, the court in the second *Bank of Nova Scotia* case said:

In a world where commercial transactions are international in scope, conflicts are inevitable. Courts and legislatures should take every reasonable precaution to avoid placing individuals in the situation [the Bank] finds [it]self. Yet, this court simply cannot acquiesce in the proposition that United States criminal investigations must be thwarted whenever there is conflict with the interests of other states.

*Bank of Nova Scotia*, 740 F.2d at 828.

214. *In re Uranium Antitrust Litigation*, 480 F. Supp. 1138, 1148 (N.D. Ill. 1979) (Marshall, J.).

215. *Id.*

inherently unworkable in this case. The competing interests here display an irreconcilable conflict on precisely the same plane of national policy. Westinghouse seeks to enforce this nation's antitrust laws against an alleged international marketing arrangement among uranium producers, and to that end has sought documents located in foreign countries where these producers conduct their business. In specific response to this and other related litigation in American courts, three foreign governments have enacted nondisclosure legislation which is aimed at nullifying the impact of American antitrust legislation by prohibiting access to those same documents. It is simply impossible to judicially "balance" these totally contradictory and mutually negating actions.<sup>216</sup>

In 1986, The American Law Institute adopted the *Restatement (Third) of Foreign Relations Law of the United States*. The *Restatement (Third)* describes permissible bases of a state's jurisdiction to prescribe,<sup>217</sup> but provides that the exercise of jurisdiction to prescribe is not allowed where to do so would be "unreasonable."<sup>218</sup> The *Restatement (Third)* requires deferral to a foreign state's clearly greater interests. Section 403 provides:

(1) Even when one of the bases for jurisdiction under § 402 is present, a state may not exercise jurisdiction to prescribe law with respect to a person or activity having connections with another state when the exercise of such jurisdiction is unreasonable. . . .

(3) When it would not be unreasonable for each of two states to exercise jurisdiction over a person or activity, but the prescriptions by the two states are in conflict, each state has an obligation to evaluate its own as well as the other state's interest in exercising jurisdiction, in light of all the relevant factors, Subsection (2); a state should defer to the other state if that state's interest is clearly greater.<sup>219</sup>

Moreover, the *Restatement (Third)* specifically deals with American requests for

216. *Id.*

217. RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 402 (1986). Section 402 provides: Subject to § 403 a state has jurisdiction to prescribe law with respect to

- (1) (a) conduct that, wholly or in substantial part, takes place within its territory;
- (b) the status of persons, or interests in things, present within its territory;
- (c) conduct outside its territory that has or is intended to have substantial effect within its territory;
- (2) the activities, interests, status, or relations of its nationals outside as well as within its territory; and
- (3) certain conduct outside its territory by persons not its nationals that is directed against the security of the state or against a limited class of other state interests.

*Id.* § 402.

218. *Id.* § 403(2). Section 403(2) provides the following test of reasonableness:

(2) Whether exercise of jurisdiction over a person or activity is unreasonable is determined by evaluating all relevant factors, including, where appropriate:

- (a) the link of the activity to the territory of the regulating state, i.e., the extent to which the activity takes place within the territory, or has substantial, direct, and foreseeable effect upon or in the territory;
- (b) the connections, such as nationality, residence, or economic activity, between the regulating state and the person principally responsible for the activity to be regulated, or between that state and those whom the regulation is designed to protect;
- (c) the character of the activity to be regulated, the importance of regulation to the regulating state, the extent to which other states regulate such activities, and the degree to which the desirability of such regulation is generally accepted;
- (d) the existence of justified expectations that might be protected or hurt by the regulation;
- (e) the importance of the regulation to the international political, legal, or economic system;
- (f) the extent to which the regulation is consistent with the traditions of the international system;
- (g) the extent to which another state may have an interest in regulating the activity; and
- (h) the likelihood of conflict with regulation by another state.

*Id.*

219. *Id.* § 403.

disclosure of information abroad.<sup>220</sup> Section 441 provides a foreign compulsion defense that contains a “territorial” preference<sup>221</sup> to the country where the witness or documents are located: in general, a state may not require a person

- (a) to do an act in another state that is prohibited by the law of that state or by the law of the state of which he is a national; or
- (b) to refrain from doing an act in another state that is required by the law of that state or by the law of the state of which he is a national.<sup>222</sup>

Section 442(2) similarly provides respect for rival national interests in the explicit context of orders to compel production of documents abroad that run afoul of foreign “blocking statutes”:

If disclosure of information located outside the United States is prohibited by a law, regulation, or order of a court or other authority of the state in which the information or prospective witness is located, or of the state of which a prospective witness is a national,

. . .

- (b) a court or agency should not ordinarily impose sanctions of contempt, dismissal, or default on a party that has failed to comply with the order for production, except in cases of deliberate concealment or removal of information or of failure to make a good faith effort . . . .<sup>223</sup>

Courts may, however, draw adverse inferences from failure to comply with orders for the production of documents.<sup>224</sup> Thus “blocking statutes” designed to thwart American investigators (such as Swiss Penal Code Article 273) are not necessarily given the same deference as substantive rules of foreign law.<sup>225</sup>

#### D. *Perceptions of Privacy Rights*

It is hard to deal with foreign secrecy laws without first examining one’s own cultural attitude to the emotionally charged term “secrecy,” often an invidious term for the privacy or anonymity or confidentiality that government agencies consider

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220. *Id.* § 442 (entitled “Requests for Disclosure: Law of the United States”):

- (1) (a) A court or agency in the United States, when authorized by statute or rule of court, may order a person subject to its jurisdiction to produce documents, objects, or other information relevant to an action or investigation, even if the information or the person in possession of the information is outside the United States.
- (b) Failure to comply with an order to produce information may subject the person to whom the order is directed to sanctions, including finding of contempt, dismissal of a claim or defense, or default judgment, or may lead to a determination that the facts to which the order was addressed are as asserted by the opposing party.
- (c) In deciding whether to issue an order directing production of information located abroad, and in framing such an order, a court or agency in the United States should take into account the importance to the investigation or litigation of the documents or other information requested; the degree of specificity of the request; whether the information originated in the United States; the availability of alternative means of securing the information; and the extent to which noncompliance with the request would undermine important interests of the United States, or compliance with the request would undermine important interests of the state where the information is located.

*Id.*

221. *Id.* § 441 comment b.

222. *Id.* § 441(1).

223. *Id.* § 442(2).

224. *Id.* § 442(2)(c).

225. *Id.* § 442 reporter notes 4, 5 & 6.



pathological. American perceptions of bank secrecy affect how American courts and government agencies issue and enforce disclosure orders. Often, Americans see secrecy as nothing more than an intrinsically improper way to facilitate tax fraud, drug running, and money laundering.<sup>226</sup>

The Swiss perception of bank secrecy contrasts sharply with the American view. One distinguished Swiss lawyer has written that "bank secrecy remains a right that is fundamental to respect for one's private life."<sup>227</sup>

The European viewpoint has much to recommend it if one considers the plight of those who may face persecution in exotic countries. Swiss bank secrecy may be the only hope for a refugee's economic renewal. The plight of German Jews in the 1930's is particularly instructive in this regard. The Swiss bankers often devised ingenious systems for distinguishing between German clients' voluntary instructions to pay from those that were coerced.<sup>228</sup> The difficult dispersion of many Sephardic Jews from Arab lands provides a more modern-day illustration of the legitimate need for secrecy laws.

The American perception of the secrecy inherent in the attorney-client privilege differs from the American perception of bank secrecy. Privilege is one basis for challenge of the I.R.S. administrative summons, and discovery requests do not extend to privileged matters.<sup>229</sup>

It may be significant that American attempts to breach foreign secrecy laws have focused on foreign bankers rather than foreign lawyers. In part, this may be due to the context in which the cases arise: insider trading is carried on through a foreign nominee bank account, and the fruits of tax evasion are deposited in an overseas financial institution.

However, the explanation might also include cultural factors. The attorney-client privilege (even if it does not extend to the identity of the client<sup>230</sup>) is so deeply ingrained in the American psyche that tinkering with it can be expected to create considerable institutional fuss from the legal profession. The type of society we desire requires respect for attorney-client relationships. In contrast, an attack on the secrecy of the bank industry involves a relationship that, in the United States, has never known a similar privilege.

226. See S. REP. NO. 130, 99th Cong., 1st Sess. (1985) (entitled "Crime and Secrecy: The Use of Offshore Banks and Companies"); STAFF OF PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS, 98th Cong., 1st Sess. (Comm. Print 1983). See also R. GORDON, TAX HAVENS AND THEIR USE BY U.S. TAXPAYERS 197-214 (1981).

227. Aubert, *Quelques Aspects de la Portée du Secret Bancaire en droit pénal interne et dans l'entraide judiciaire internationale*, 1984 REVUE PENALE SUISSE 167 (noting that "le secret bancaire demeure un droit fondamental du respect de la vie privée.").

228. See N. FAITH, SAFETY IN NUMBERS 82-87 (1982).

229. See *United States v. Arthur Young & Co.*, 677 F.2d 211 (2d Cir. 1982); FED. R. CIV. P. 26(b)(1); FED. R. CRIM. P. 17(c); 15 U.S.C. § 1312(c)(1) (1988).

230. See MCCORMICK ON EVIDENCE § 90, at 215 (E. Cleary ed. 1984).

The traditional and still generally applicable rule denies the privilege for the fact of consultation or employment, including the component facts of the identity of the client, such identifying facts about him as his address and occupation, the identity of the lawyer, and the scope or object of the employment.

*Id.* § 90, at 215. Recently, federal grand juries have subpoenaed lawyers to provide names of clients who are known to represent the upper echelons of organized crime, in an attempt by the Justice Department to discover the "kingpins" behind racketeering.

In Switzerland, the bankers' privilege is not completely analogous to that of lawyers. Communications with persons listed in article 321 of the Swiss Penal Code<sup>231</sup>—including clergy, lawyers, and doctors, but *not* bankers—are subject to the strictest and most absolute of professional secrecy. However, secrecy under article 47 of the Banking Law is specifically subject to what the Swiss call the "duty to . . . present testimony."<sup>232</sup> So bankers may be required to give testimony about customers in judicial investigations of suspected criminal activity.

Perhaps one difference between lawyers and bankers is that attorneys, like doctors and clergy, require a confidential relationship with the client interlocutor that is less critical to the banker providing honest financial advice. This is obviously a distinction about which reasonable people may differ, and which does not foreclose speculation about the merit of viewing the banker's privilege as we do the attorney-client privilege.

#### E. *Economic Regulations and Political Goals*

American banks have developed a thriving business in Eurodollar accounts (dollar-denominated deposits held in European branches and subsidiaries) of foreign customers. Foreign depositors obviously do not want their accounts to be frozen during political disputes between their home country and the United States. The United States, however, has used Eurodollar freezes as a tool in the exercise of foreign policy,<sup>233</sup> creating yet another conflict on the liability side of the bank's balance sheet.

The tension between the security of deposits and the vicissitudes of American politics was played out when, in 1979, the United States Treasury froze Iranian assets,<sup>234</sup> and again in 1986 when President Reagan ordered a freeze of all dollar-denominated Libyan assets, including those held in foreign branches of American banks.<sup>235</sup>

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231. Article 321 provides:

Les ecclésiastiques, avocats, défenseurs en justice, notaires, contrôleurs astreints au secret professionnel en vertu du code des obligations, médecins, dentistes, pharmaciens, sage-femmes, ainsi que leurs auxiliaires, qui auront révélé un secret à eux confié en vertu de leur profession ou dont ils avaient eu connaissance dans l'exercice de celle-ci, seront, sur plainte, punis de l'emprisonnement ou de l'amende.

CP art. 321 (Switz.).

232. Article 47(4) of the Loi fédéral sur les banques reads:

Sont réservées les dispositions de la législation fédérale et cantonale statuant l'obligation de renseigner l'autorité et de témoigner en justice.

*Id.*

233. For the most comprehensive analysis of freeze orders and Eurodollar deposits, see Smedresman & Lowenfeld, *supra* note 56. See also Rutzke, *The Libyan Asset Freeze and Its Application to Foreign Government Deposits in Overseas Branches of United States Banks*: Libyan Arab Foreign Bank v. Banker's Trust Co., 3 AM. U.J. INT'L L. & POL'Y 241 n.1 (1988) (discussing the President's powers to order asset freezes in wartime under the Trading With the Enemy Act of 1917, 50 U.S.C. app. § 5(b)(1)(B) (1982), and in peacetime under the International Emergency Economic Powers Act of 1977, 50 U.S.C. § 1702(a)(1)(B) (1982)).

234. Pursuant to the International Emergency Economic Powers Act, 50 U.S.C. § 1701 (1982) and the National Emergencies Act, 50 U.S.C. § 1601 (1982) and the Presidential power of delegation, 3 U.S.C. § 301 (1982). See Edwards, *Extraterritorial Application of the U.S. Iranian Assets Control Regulations*, 75 AM. J. INT'L L. 870, 871 (1981).

235. President Reagan acted under the International Emergency Powers Act in issuing Exec. Order No. 12,544, 3 C.F.R. 183 (1987), reprinted in 50 U.S.C. § 1701 (Supp. III 1985).

The freeze of Iranian assets, ordered ten days after the taking of American hostages in Iran<sup>236</sup> forbade any payment to Iran<sup>237</sup> by "persons subject to the jurisdiction of the United States" and defined that term to include foreign branches and subsidiaries of American banks.<sup>238</sup> As subsequently amended, the regulations allowed payments to be made to Iran on deposits denominated in currencies other than the dollar.<sup>239</sup> As the hostage crisis dragged on, the regulations were further amended to bar payments to private individuals in Iran. In total, the freeze is reported to have affected over nine billion dollars of Iranian assets.<sup>240</sup>

The IMF Articles permit member countries to obtain approval of currency restrictions imposed for reasons of national security,<sup>241</sup> which approval the United States obtained for both the original and the subsequent asset freeze. The Iranians then filed suits against six American banks in London<sup>242</sup> and two in Paris<sup>243</sup> to obtain payment on its deposits. No judgments were handed down in these suits because the crisis was eventually resolved by the release of the hostages and the creation of a

236. The hostages were taken on Nov. 4, 1979. See generally Edwards, *supra* note 234, at 870-71.

237. 44 Fed. Reg. 65,956 (1979) (codified at 31 C.F.R. § 535.201 (1980)). The regulation reads as follows:

(a) The term "Iran" and "Iranian Entity" includes:

- (1) The state and the Government of Iran as well as any political subdivision, agency, or instrumentality thereof or any territory, dependency, colony, protectorate, mandate, dominion, possession or place subject to the jurisdiction thereof;
- (2) Any partnership, association, corporation, or other organization substantially owned or controlled by any of the foregoing;
- (3) Any person to the extent that such person is, or has been, or to the extent that there is reasonable cause to believe that such person is, or has been, since the effective date acting or purporting to act directly or indirectly on behalf of any of the foregoing;
- (4) Any territory which on or since the effective date is controlling or occupied by the military, naval or police forces or other authority of Iran; and,
- (5) Any other person or organization determined by the Secretary of the Treasury to be included within paragraph (a) hereof.

*Id.*

238. 31 C.F.R. § 535.329 (1980) stated:

The term "person subject to the jurisdiction of the United States" includes:

- (a) Any person wheresoever located who is a citizen or resident of the United States;
- (b) Any person actually within the United States;
- (c) Any corporation organized under the laws of the United States or of any state, territory, possession, or district of the United States; and
- (d) Any partnership, association, corporation, or other organization wheresoever organized or doing business which is owned or controlled by persons specified in paragraph (b).

44 Fed. Reg. 65,956, 64,957 (1979) (codified at 31 C.F.R. § 535.329 (1980)).

239. Section 535.566 of the regulations as amended Nov. 19, 1979. 44 Fed. Reg. 66,832, 66,833 (1979) (codified at 31 C.F.R. § 535.566 (1980)).

240. *Iran is Reported Ready For a Deal to Recover Assets*, N.Y. Times, Aug. 9, 1989, at A1. The New York Times recently reported that \$1.8 billion was still frozen. See Clawson, *Tell Teheran: No Hostages, No Money*, N.Y. Times, Sept. 4, 1989, at 27.

241. IMF Articles, art. VIII § 2(a), *supra* note 76, as amended by Second Amendment to IMF Articles, art. VIII, § 2(a), *supra* note 76.

242. Bank of America National Trust and Savings Association, Bankers Trust Co., Chase Manhattan Bank N.A., Citibank N.A., Irving Trust Co., and Manufacturers Hanover Trust Co. The suits were begun against five of the six banks on Nov. 30, 1979 in the High Court of Justice, Queen's Bench Division, Commercial Court. The action against Bankers Trust was commenced some time later. The cases were consolidated for purposes of trial. Edwards, *supra* note 234, at 876 n.32.

243. The Iranian bank's actions against the Paris branches of Citibank and Bank of America National Trust and Savings Association were commenced in the Tribunal de Grande Instance, Paris. *Id.*

Iran-United States Claims Tribunal to adjudicate the claims of U.S. nationals against Iran.<sup>244</sup>

The Paris and London litigations centered primarily on whether the American banks would violate the freeze regulations by paying on the deposits. The American banks argued that they routinely made transfers into and out of a clearing system in New York to service their Eurodollar accounts (the Clearing House Interbank Payments System, or CHIPS),<sup>245</sup> which meant that to pay on the Iranian deposits they would have to transfer funds in the United States in violation of the law of the country of performance. The Iranians replied that the banks could make the payments required using funds available to them outside the United States. If performance could be accomplished entirely outside the United States, French and British courts might normally ignore the attempted extraterritorial reach of the regulations, unless they fell under Article VIII(2)(b) of the IMF Articles.<sup>246</sup>

The applicability of this IMF Article on exchange contracts turned on at least three issues: (1) Were the American freeze regulations "exchange control regulations?"; (2) Were the deposits "exchange contracts" involving the currency of the United States?; (3) Were the American freeze regulations "imposed consistently with this IMF Agreement?"<sup>247</sup>

At first blush, the United States Iranian Assets Control Regulations took the form of "exchange control regulations" in that they controlled international payments or transfers of dollars. However, several respected scholars have argued that under the IMF Articles, it is not the form of the regulations that matters, but their purpose. The Iranian freeze regulations, of course, were not intended to protect the soundness of the dollar and to control the balance of payments—the traditional rationale for exchange controls—but rather to force the release of hostages.<sup>248</sup>

As already mentioned, opinions diverge on the definition of "exchange contracts." The American banks argued for the broad view that any contract that requires an international payment or transfer of currency constitutes an "exchange contract." The Iranians argued that no exchange of currencies was contemplated by

244. *Id.* Of the \$9.97 billion frozen, the tribunal transferred \$3.89 billion to Iran with the rest remaining in escrow accounts or being paid to American companies or Iranian interests. *Iran is Reported Ready For a Deal to Recover Assets*, N.Y. Times, Aug. 9, 1989, at A1, A6.

245. The Clearing House Interbank Payments System (CHIPS), located in New York, is the United States domestic clearing system for international payments. It clears, on average, between \$600 and \$700 million a day, and has been known to clear \$1.25 trillion in one day. It has 140 international banks with offices in New York as members. *Big-Buck Transfers a Big Risk*, Nat'l L.J., Aug. 14, 1989, at 1.

246. IMF Articles, art. VIII(2)(b), *supra* note 76, which provides:

Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member. In addition, members may, by mutual accord, cooperate in measures for the purpose of making the exchange control regulations of either member more effective, provided that such measures and regulations are consistent with this Agreement.

Article VIII also provides, in Section 2(a) that

Subject to the provisions of Article VII, Section 3(b) and Article XIV, Section 2, no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions.

247. Edwards, *supra* note 234, at 883.

248. See *id.* at 884. See also Comment, *The Iranian Assets Control Regulations and the International Monetary Fund: Are the Regulations "Exchange Control Regulations?"*, 4 B.C. INT'L & COMP. L. REV. 203 (1981).

the contracts: they deposited Eurodollars and expected Eurodollars in return. A similar doctrinal dispute exists concerning the meaning of an exchange contract that involves the currency of the relevant IMF member. A broad definition includes any contract that affects a country's exchange resources. The opposing position holds that a contract involves the currency of a country only if that currency is named in the contract as a currency of payment, or payment is in fact necessary to the performance of the contract.

Finally, on the issue of whether the U.S. regulations were consistent with the IMF Articles, most authorities have held that approval by the IMF under article VIII should be conclusive as to consistency with the Articles.<sup>249</sup>

The release of the American hostages and the creation of the Iran-United States Claims Tribunal terminated the Paris and London cases. Scholars and practitioners were thus denied—though only for a season—judicial determination of the nature of deposit contracts and the necessity of performance of dollar transactions in the United States.

It should come as no surprise that many of the issues raised with respect to the Iranian freeze resurfaced six years later, when President Reagan ordered the freeze of Libyan assets.<sup>250</sup> The Executive Order blocked

all property and interests in property of the Government of Libya, its agencies, instrumentalities and controlled entities and the Central Bank of Libya that are in the United States, that hereafter come within the United States or that are or hereafter come within the possession or control of U.S. persons including overseas branches of U.S. persons.<sup>251</sup>

When the Libyan Arab Foreign Bank (LAFB) asked Bankers Trust for repayment of the funds held in LAFB's London account,<sup>252</sup> the Libyans expressed a willingness to accept payment by any commercially recognized means, including in sterling.<sup>253</sup> Bankers Trust claimed the President's order prevented it from complying. The issue arose whether the operation of the Eurodollar account necessarily involved the transfer of funds through CHIPS, thereby requiring Bankers Trust to commit an

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249. See Edwards, *supra* note 234, at 895 n.107 (listing authorities). The director of the Legal Department of the IMF has stated that currency restrictions approved by the IMF under IMF art. VIII, § 2(a) constitute "exchange control regulations maintained consistently with the Fund's Articles." *Id.* at 900.

250. *Libyan Arab Foreign Bank v. Bankers Trust*, [1989] 3 W.L.R. 314 (Q.B. 1987), [1988] 1 Lloyd's Rep. 259 (Staughton, J.), *reprinted in* 26 INT'L L. MATERIALS 1600 (1987); *Libyan Arab Foreign Bank v. Manufacturers Hanover Trust*, [1988] 2 Lloyd's Rep. 494, [1989] 1 Lloyd's Rep. 608 (Q.B. 1989) (Hirst, J.).

251. Exec. Order No. 12,544, 3 C.F.R. 183 (1986), *reprinted in* 50 U.S.C. § 1701 (Supp. III 1985). This was the second such order in as many days. The previous one blocked trade and other transactions with Libya. Exec. Order No. 12,543, 3 C.F.R. 181 (1986), *reprinted in* 50 U.S.C. § 1701 (Supp. III 1985). See also *Attack Cement v. Roumanian Bank for Foreign Trade*, [1989] 1 Lloyd's Rep. 572 (C.A.) which restated the rule that actions relating to a bank account are governed by the law of the place where the account is kept.

252. The Libyans actually had two different accounts: a London account with a balance of about \$131 million, and a New York account. Part of the litigation concerned a sum of about \$161 million that Bankers Trust was instructed by the Libyans to transfer out of the New York account into the London account just hours before the President issued his second blocking order. The dispute was essentially factual and does not interest us here. In effect, the British court held that Bankers Trust was in breach when it refused to carry out the instructions received and was held liable for the sum. *Bankers Trust*, [1989] 3 W.L.R. at 317-19. Of course, this interim holding did not decide the issue of whether Bankers Trust could pay the transferred amount to the Libyans out of the London account.

253. *Id.* at 328.

illegal act in the United States.<sup>254</sup> The Libyans' banking relationship with Bankers Trust was complicated. All operations on that account were conducted through New York, where the Libyans maintained a 500,000 dollar, interest-free, minimum "peg" balance. Any excess above the minimum balance was to be transferred daily to the London account and any deficit was to be made up from that account. As a result, Mr. Justice Staughton found that it was "a term of that arrangement that all the Libyan bank's transactions should pass through New York."<sup>255</sup>

Mr. Justice Staughton assumed that it was a well-established principle of English conflicts law that "[p]erformance of a contract is excused if (i) it has become illegal by the proper law of the contract, or (ii) it necessarily involves doing an act which is unlawful by the law of the place where the act is to be done."<sup>256</sup>

As for the proper law of the contract,<sup>257</sup> the judge stated that the contract between a bank and its customer is generally governed by the law of the place where the account is kept, absent agreement to the contrary.<sup>258</sup> Despite the fact that the account was operated "through" New York, the account was kept in London because the actual entries on it were made there. Because of the unique method of operating the London account in tandem with the New York account, the court was prepared to concede that some aspects of the two-headed contractual relationship were governed by New York law, although the rights and obligations of the parties with respect to the London account itself were governed by English law.<sup>259</sup>

The determination of the proper law was of great significance. When the Libyans were negotiating the terms of their relationship with Bankers Trust in 1980, the Iranian assets freeze was very much on their minds. Staughton summarized their concern as follows:

Political risk must commonly be an important factor to those who deposit large sums of money with banks; the popularity of Swiss bank accounts with some people is due to the banking laws of the Cantons of Switzerland. And I have already found, on the evidence of Bankers Trust, that the Iranian crisis was at the back of everyone's mind in 1980.<sup>260</sup>

Thus he concluded, "Whatever considerations did or did not influence the parties to this case, I believe that banks generally and their customers normally intend the local law to apply."<sup>261</sup>

For American banks, the English territorial bias on what constitutes the proper law is an important element in the attractiveness of London as a center for Eurodollar accounts. The English courts' refusal to give extraterritorial effect to American laws has the prophylactic effect of protecting foreign depositors to some extent from application of American economic regulations.

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254. *Id.* at 335, 345-46.

255. *Id.* at 322.

256. *Id.* at 328.

257. The law that the parties intend to govern the contract or the law of the place to which the contract is most closely connected. See A. DICEY & J. MORRIS, *supra* note 109, at 1161.

258. *Bankers Trust*, [1989] 3 W.L.R. at 330.

259. *Id.* at 330-32.

260. *Id.* at 331.

261. *Id.*

The policy conflict is stark. On the one hand, American banks are interested in taking deposits abroad.<sup>262</sup> The more money taken in, the more money can be lent out with the appropriate "spread" between the interest rate paid on deposits and the rate charged on loans. More deposits generally mean more loans and thus more profits. Yet many prospective customers attracted to the financial stability of American institutions are wary of subjecting their money to the jurisdiction of the American government and its potential asset freezes.

In determining whether paying the Libyans in London necessarily involved the commission of an illegal act in the United States, the court distinguished between the performance itself and the preparation for performance. The court viewed the transfer of funds in New York through the CHIPS system as merely preparatory to the payment of the deposit in London.<sup>263</sup> What is more, the court found that the Libyans had no intention or interest in having Bankers Trust commit an illegal act in New York,<sup>264</sup> and were prepared to accept payment by any commercially recognized means that bypassed New York. Staughton found that no implied term existed that payment be made through CHIPS<sup>265</sup> and concluded that the Libyans were entitled to demand payment in cash in London (either in dollars or the sterling equivalent) and that such payment, while cumbersome, did not involve any illegal activity in New York.<sup>266</sup>

The Bankers Trust litigation raised liability-side policy conflicts at several different levels. The American attempt to apply its economic regulation to foreign branches of its financial institutions ran into the English insistence on the sovereignty of its local law over local operations of local branches. Both banker and depositor were caught in the middle. The American bank itself was in a deeply ambivalent posture. On the one hand, the bank's duty as an American institution was to respect American law. On the other hand, the bank could not help recognizing the loss of confidence among foreign depositors that would result if Eurocurrency accounts were subject to American asset freezes. A victory by Bankers Trust would have been Pyrrhic if it had led to a diminution of its share of Eurodollar deposits.

The Libyans' action for payment on their deposits parallels the actions by American banks for payment on foreign debt subject to exchange controls. In both cases the sanctity of contract—honoring one's word and meeting shared expectations—ran headlong into measures intended to safeguard vital national interests. Hostages and freeze orders, like debt crisis and exchange controls, claimed a problematic priority over normal rules about promises.

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262. See Rutzke, *supra* note 233, at 252–54 (discussing the reasons behind the creation of Eurodollar accounts).

263. *Bankers Trust*, [1988] 3 W.L.R. at 329.

264. *Id.* at 330.

265. *Id.* at 341–43, 344. Staughton, J., also rejected the position espoused by Dr. Mann that the "Eurodollar market is a mere account market rather than a money market" and that therefore the only form of payment that the Libyans could demand was a credit effectuated through CHIPS to their account at a nominated beneficiary bank.

266. *Id.* at 341–43, 349–50. Although it is unclear whether Bankers Trust had reached a decision on whether to appeal, the decision was taken out of their hands when the United States Treasury Department without comment issued a license under the Libyan Sanctions Regulations, 31 C.F.R. § 550.209 (1987), allowing the bank to pay the judgment with interest. Wall St. J., Oct. 13, 1987, at 31, col. 1.

One commentator<sup>267</sup> has suggested that the court in the *Bankers Trust* case should have followed a "balancing of the interests approach," rather than a "cash-based" legal reasoning approach. By applying the principles of the *Restatement of Foreign Relations Law of the United States*,<sup>268</sup> she suggests, a British court might conclude that the United States had an interest in blocking Libyan assets sufficiently strong to make it unreasonable for Britain to prescribe a conflicting rule.<sup>269</sup> Personally I remain skeptical, however, that a British court could bring itself to subordinate its interests to those of American policies when courts of the United States have exhibited an unwillingness to defer to foreign interests in similar cases.<sup>270</sup>

The *Bankers Trust* case held that the Libyans could unilaterally modify the bifurcated nature of the managed account arrangement linking London and New York funds. The court concluded that LAFB had properly terminated the account by telex in either April or July of 1986, leaving the London account separate from the New York account.<sup>271</sup> The court did not consider whether the right to modify the arrangement unilaterally was an interest in property that was frozen under the January 8th order. However, this issue was dealt with in a later case involving similar facts.

This time, the case was brought against Manufacturers Hanover Trust (MHT).<sup>272</sup> The court dealt with the alleged illegality, under the American freeze order, of unilateral Libyan termination of the managed account arrangement. Concluding that the account transfer arrangement did not have any economic value, the court found that the bifurcated arrangement was not an interest in property that could be frozen by Presidential order.

In an article examining asset control regulations and discussing the LAFB cases, one scholar has argued that United States Government sanctions with extraterritorial effect will always be subject to attack in the relevant foreign forum.<sup>273</sup> He goes on to state that although this potential problem might be met by skillful drafting in the deposit contract, a bank might fail to anticipate the need for such a clause or it might feel uncomfortable about negotiating such a clause with a foreign client.<sup>274</sup> Thus, he concludes that banks involved in international activities are in effect left to absorb the risk of future sanctions as best they can.<sup>275</sup>

The LAFB cases illustrate the need for coordinated banking supervision at the international level. Currently, one means of such supervision is being accomplished

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267. Joyce, *Libyan Arab Foreign Bank v. Bankers Trust: Common Law Meets Its Limits?*, 29 HARV. INT'L L.J. 451 (1988).

268. At the time the Comment was written, the *Restatement (Third)* was still in draft form. Thus, the author made reference to RESTATEMENT (REVISED) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 403 (Tent. Draft No. 7, 1986). Section 403 is discussed *supra* at footnote 218.

269. Joyce, *supra* note 267, at 472.

270. See *supra* notes 214-16 and accompanying text for discussion of *In re Uranium Antitrust Litigation*.

271. *Libyan Arab Foreign Bank v. Bankers Trust*, [1989] 3 W.L.R. 314, 327-28 (Q.B. 1987).

272. *Libyan Arab Foreign Bank v. Manufacturers Hanover Trust*, [1988] 2 Lloyd's Rep. 494, [1989] 1 Lloyd's Rep. 608 (Q.B. 1989). MHT (unlike *Bankers Trust*) had stamped its account documents as follows: "This deposit or placement is payable at Manufacturers Hanover Trust Company, London and shall be governed by the laws of England."

273. Malloy, *U.S. International Banking and Treasury's Foreign Assets Controls: Springing Traps for the Unwary*, 8 ANN. REV. BANKING L. 181, 266-67 (1989).

274. *Id.*

275. *Id.*



through the Basle Supervisors' Committee. Comprised of representatives of the central banks and bank supervisory authorities from eleven leading industrialized countries and Luxembourg, the Committee's goals include a convergence of bank supervisory practices.<sup>276</sup> The Committee's most recent and most significant efforts have been in the capital adequacy area. In July 1988, the Committee issued a final proposal setting forth a suggested framework for measuring the adequacy of capital retained by banks and suggesting a minimum capital amount that all banks operating internationally should seek to maintain. Such a framework is important to prevent what the Committee perceives to be an undesirable further erosion of bank capital and to provide a better means of determining the levels of capital employed or maintained by major international banks. Although the Basel proposal has no binding effect, the governments represented on the Committee have agreed to follow the principles of the report.<sup>277</sup>

#### IV. CONCLUSION

The world debt crisis highlights several themes that operate as a refrain on both the asset and the liability sides of the bank balance sheet. Foremost among these is that agreements—whether loans or deposits—are meant to be enforced. Without confidence that obligations will be honored, financial intermediaries will be unable to fulfill their function of channeling savings to enterprises and to individuals in need of capital.

Yet vital national interests inevitably present excuses for government actions that reduce contract enforceability. Exchange controls are among the ways that both lending and borrowing nations indulge the temptation to interfere with the banker-customer relationship when parochial national goals are at stake. The legitimate interest of debtor countries in protecting currency reserves competes with the interest of the lender's jurisdiction in enforcing freely accepted loans.

Policy conflicts within nations also cast themselves as issues that work their way into the lawyer's domain. On the asset side of the bank's balance sheet, intricacies of the act of state doctrine and sovereign immunity implicate two not entirely consistent objectives: the need for confidence in the enforceability of international loan agreements, on the one hand, and on the other hand, the desire to reduce the risk that judicial decisions will hinder sensitive government-to-government negotiations.

Finally, the community of nations as an aggregate knows a common interest in monetary cooperation and free payment on current transactions that does not always marry well with the respect that members of the global community expect each other to show toward their exchange control regulations.

On the liability side of the balance sheet, unfortunate conflicts have arisen between the United States and some of its important allies and trading partners, notably Switzerland and Great Britain. To enforce American tax and securities reg-

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276. Norton, *The Work of the Basle Supervisors' Committee*, 23 INT'L LAW. 245, 248-49 (1989). See generally, R. DALE, *THE REGULATION OF INTERNATIONAL BANKING* (1984).

277. Norton, *supra* note 276, at 259-62.

ulations, American courts have sought disclosure of bank records despite secrecy laws intended to preserve the integrity of private banking. American reactions to events in Iran and Libya led to freezing of Eurodollar deposits within British territory, and the consequential conflict with British assertion of sovereignty over accounts at bank branches within its territory.

Within the United States, the foreign investor's desire for anonymity and freedom from tax has played itself out in a tension between measures to attract foreign capital, and the need for information to enforce its economic regulations. And the interest of American banks in attracting deposits has run afoul of the government's use of economic regulations as an instrument of foreign policy.

Bank secrecy plays a part in the debt crisis because it facilitates capital flight from debtor countries. Depositors eager for financial anonymity include residents of politically unstable lands seeking to avoid discriminatory confiscation and tax evaders seeking a kinder fiscal environment. In addition, drug runners and fraudsters seek to hide the fruit of their criminal activity. Whether the world would be a better place without bank secrecy depends on whether one takes the perspective of the victim of Nazi persecution who was helped to safety by a Zurich bank account, or the outlook of law enforcement officials trying to catch a cocaine dealer. Treaties that lift bank secrecy must distinguish between such dramatically different uses of financial confidentiality.

These competing policies result in a tapestry of legal rules woven by the interplay of rival objectives. One should not be surprised that the colors of this tapestry do not always harmonize. As Emerson reminded us, a foolish consistency is the hobgoblin of little minds. However, insofar as clashing rules make it more difficult for trans-border banking to play a constructive role in the global wealth creation process, lawyers in international finance have a duty to face squarely and openly the connections between conflicts engendered on both sides of the balance sheet so as to elaborate an explicit principled priority among the competing goals and rules.